Module 8: Investments in Rural Finance for Agriculture

Providing financial services to households and agribusiness in poorer and marginal rural areas remains a challenge for the World Bank and other funding agencies. The adoption of a financial systems approach and the expansion of the microfinance sector have led to significant breakthroughs in performance, outreach, and lending volumes. Such breakthroughs rarely have extended to more marginal rural areas dependent on agriculture, however. Even so, some progress has been made recently in providing financial services to poor rural households with diversified nonfarm sources of income or income from nonseasonal agricultural activities.

Several factors heighten the costs and risks of financing agriculture and cause financial service providers to regard investment in agriculture as unattractive (box 8.1). However, recent efforts by the World Bank and other organizations are starting to bear fruit in the form of emerging models and successful approaches. Rather than recapitulating the comprehensive and well-documented treatments of the challenges and failures of agricultural finance (World Bank 2003; IADB 2001; Yaron, Benjamin, and Piprek 1997), this module explores promising new directions in rural finance for agriculture and identifies lessons for policy and lending.

Within the current financial systems approach, financing for agriculture is seen as part of a comprehensive rural finance strategy. The terms "rural finance for agriculture" and "financing for agriculture" are used interchangeably throughout this module to define *all financial services provided to those engaged in the agricultural sector*. The module focuses on the provision of financial services for agricultural activities and to agriculturally dependent households, though most services do not exclusively provide financing for agriculture. They also provide financial services to nonagricultural rural and, in some cases, urban communities. Service providers include formal, semiformal and informal institutions, ranging from full-service banks to specialized agricultural finance institutions, microfinance institutions (MFIs), financial cooperatives), credit unions,

Box 8.1 Challenges of providing financing for agriculture

- *High, interrelated covariant risks:* Owing to variable rainfall (especially for nonirrigated crop production); pests and diseases; price fluctuations; and constrained smallholder access to inputs, advice, and markets.
- *Dispersed demand for financial services:* Owing to low population densities; small size of individual transactions.
- *High information/transaction costs for service providers:* Owing to the remoteness of clients and heterogeneity among communities and farms. This challenge creates the potential for information asymmetries and moral hazard risks.
- *Seasonality of agricultural production (crop production in particular):* Leads to a lag between investment needs and expected revenues, and consequent liquidity management challenges.
- *Lack of usable collateral:* Owing to ill-defined property and land-use rights, costly or lengthy registration procedures, and social constraints to foreclosure.

Source: Authors

savings and loan associations, traders, and processors. Providers encompass all types of financial services (credit, savings, money transfers, leasing, and insurance)[1] for agricultural activities, which are defined broadly to include primarily production but also processing, distribution, and marketing. This module gives particular emphasis to groups that presently have only limited access to financial services, such as poor, agriculturally dependent households in less-favored (low productivity, more remote) rural areas.

Rationale for Investment

Constraints to agricultural development are many. Access to financial services is only one response to these constraints, but improvements in the provision of—and access to—financing for agriculture can meet a range of needs, and it can be critical to the success of agricultural development programs. Indeed, many investments in agriculture depend on access to appropriate financial services. At the production level, financing for agriculture can enable farmers to introduce irrigation or other technologies; finance input and marketing costs; cofinance extension and information services; bridge the preharvest income gap; prevent sales of produce immediately following harvest at low prices; smooth seasonal income flows through deposit facilities, access to remittances, and existence of bank overdraft lines; or insure against price or yield fluctuations. If agribusinesses cannot access financial services, their capacity to finance and supply farmers, and to buy and process farm produce, is restricted.

Past Investment Experiences

Since the 1950s, the donor community has made large-scale investments in recognition of the importance of supporting financing for agriculture. Widespread development of sound and sustainable financial systems for agriculture has yet to occur, however, and the challenges described above remain. Attention frequently has been drawn to the apparent failure of past approaches, and in particular to the directed credit programs of the 1960s to the mid-1980s. Although these programs lent short-term impetus to agricultural production, they have been criticized as costly, unsustainable, and creating a misperception of free credit, thus jeopardizing future efforts to create sustainable financial institutions. Since the 1980s, attention has switched to the development of sustainable financial institutions providing services to poor clients. This change in emphasis has entailed greater donor support to the establishment of an appropriate policy, regulatory, and legal environment for financial institutions, as well as support for the development of innovative approaches to reach poorer clients.

During the 1990s, the number of World Bank operations with rural and microfinance components rose steadily, with average annual lending of US$630 million (World Bank 2003). Yet the relative share of agriculture in total Bank operations with rural and microfinance components declined from 65 percent during fiscal years 1992 to 1994 to only 27 percent in 2001. This decline is attributed to the trend to include microfinance and grant components in projects for other sectors, the poor performance of agricultural

[1] This module is primarily concerned with credit, savings, and leasing. Insurance is addressed in Module 11: "Managing Agricultural Risk, Vulnerability, and Disaster."

credit lines and agricultural banks, and the Bank's Operational Policy (OP) 8.30, which limits the use of subsidized credit (box 8.2). The focus of recent Bank operations has therefore shifted from providing credit to agricultural production (especially for larger farms) and agribusiness, to providing small loans for off-farm activities and savings services. Although these operations have had some success, they are no replacement for previous agriculturally focused operations. The development of viable mechanisms to address specific demands for agricultural financing continues to be a challenge.

Key Policy Issues

Box 8.2 Operational Policy 8.30

- Targeted subsidies may be warranted if they are transparent, capped, explicitly budgeted, fiscally sustainable, and economically justified.
- Subsidies should not directly subsidize the ultimate clients but rather aim at building the capacity of financial intermediaries or supporting institutions (for example, supervisory authorities).
- Conditions are specified for acceptable targeted credit that fosters a sustainable flow of financial services to underserved groups (such as the poor, women, and microentrepreneurs) and that is accompanied by reforms to address problems in institutional infrastructure and financial markets.
- Financial Intermediary Loans (FILs) should be limited to those that have sufficient institutional capacity.
- New and existing institutions that do not qualify as a "viable institution" may participate in a FIL, if they agree to an institutional development plan that includes a set of time-bound performance indicators that can be monitored, and that provides for a midterm review of progress.

Source: World Bank, Operational Manual

Financial systems development. In response to the deficiencies of past approaches to financing for agriculture, new thinking has emerged that embraces the financial systems approach, while recognizing the specific challenges of the agricultural sector and the rural setting. Financing for agriculture too often has been seen in isolation from wider financial systems development, and it has overemphasized credit as opposed to savings and other financial services. One symptom (and cause) of this situation is that the ministry of agriculture, rather than the ministry of finance, is often the partner ministry in a borrowing country for agricultural loans. Within a financial systems approach, financing for agriculture is viewed as part of the wider rural finance market. Underpinning this approach is the fact that institutions adhering to commercial principles are most likely to achieve outreach and sustainability, and that the role of the public sector should be focused on ensuring that the environment is conducive to the emergence and growth of such institutions.

This approach also recognizes that the financial system comprises a number of institutions (formal, semiformal and informal) and individuals (box 8.3). In certain cases, these institutions will be in place, with infrastructure and networks in agricultural communities that can be the basis for improving provision of financial services. The challenge for governments and donors is to identify and work with those institutions that are viable financial service providers, and, where such institutions are absent, to create the incentives and environment for them to emerge.

Box 8.3 Institutions and individuals in the rural finance system

- *Agricultural banks:* Whether privatized or state-owned, these banks have a rural network that provides financial services specifically for the agricultural sector.
- *Postal and savings banks:* These banks often act as the principal source of deposit and money transfer services in rural areas. Traditionally owned by the state, they have been commercial banks in some countries.
- *Microfinance institutions (MFIs):* Specialized institutions that can provide microfinance products targeted at the poor and low-income populations, including small-scale farmers.
- *Membership-based financial organizations (MBFOs):* Membership-based organizations can include financial cooperatives or credit unions, and savings and credit associations. Members of these organizations usually have a common bond such as community, geography, or activity.
- *Processors and traders:* A wide variety of businesses and entrepreneurs that participate in the agricultural market system and principally engage in agricultural activities (such as processing, marketing, input provision, storage) also provide credit as part of transactions.
- *Informal financial intermediaries:* These intermediaries consist of group-based models such as Rotating Savings and Credit Associations (ROSCAs), moneylenders, retail stores offering goods on credit, informal deposit collectors, and others.

Source: Authors

The financial systems approach recognizes that rural and agricultural clients need a full range of financial services, including savings, short- and long- term finance, insurance, money transfers for remittances, and leasing (box 8.4). To meet these demands, financial products must be designed to meet client needs (by using client and market research), and delivery mechanisms must be adapted to provide low-cost, convenient access.

Box 8.4 Financial products demanded by the rural sector

Savings: Savings mobilization contributes to an institution's sources of funds for on-lending, and savings services are equally, if not more, important to the rural poor than lending services. In the absence of formal savings opportunities, the rural poor often pay depositors or store money in insecure places.

Short-term finance: This is finance for working capital, such as inventories or agricultural inputs. Short-term finance for agricultural activities, including input supply and processing, tends to be linked to crop cycles and thus defined by the growing season.

Term finance: Term finance (FAO 2003), defined as loan terms extending beyond one year, may be used for farm machinery, irrigation equipment, land improvements, livestock, tree crops, and processing equipment. Term finance consists not only of loans but may also include the leasing of machinery and equipment. The challenges presented in box 8.1 apply even more strongly to term finance, which is more costly and risky than short-term finance, because it ties up larger amounts of money for longer periods and requires the mobilization of long-term funds (to balance assets with liabilities).

Leasing: In a lease agreement, the leaseholder pays a regular rent/lease for the use of equipment, while the legal property remains in the hands of the institution. Because collateral (the leased equipment) is readily available, leasing may be an easier product for rural financial intermediaries to provide than other term finance, but its viability depends on appropriate tax and legal

incentives.*

Money transfer for remittances: Income from national or international remittances is important for most developing economies, and it is disproportionately important for many poor rural areas where it may be the principal income source. Remittance monies can make significant contributions to consumption smoothing, and efficient mechanisms for money transfers are widely demanded by the rural poor. Care needs to be taken to ensure that access to remittance services will not be misused for money-laundering, however.

Insurance: Insurance products are in particularly high demand (and short supply) in the agricultural sector, given the risk of crop failure and price fluctuations. Insurance products span loan insurance, crop insurance, and life insurance, but experience with these products is mixed. Hedging instruments based on weather or price indices are also increasingly available.

Source: Authors

* See the IAP, "Madagascar: Microleasing for Agricultural Production."

Developing an appropriate policy framework. The public sector plays a vital role in creating suitable conditions for financial market development. Specifically, the public sector must provide the policy environment for rural finance for agriculture to flourish, including the conditions for macroeconomic growth and stability and appropriate policies for the agricultural and financial sectors. Agricultural policy reform may be necessary to remove historical biases against agriculture, to help the sector become profitable, and thereby to encourage investment. Financial sector policy needs to promote the development of financial organizations that are transparent and accountable. This effort must be supported by a strong legal and regulatory framework, including the provision of a legal basis for secure property rights, financial transactions, and savings mobilization (box 8.5).

Box 8.5 Improving the legal environment for rural finance for agriculture

Enable unsecured loan portfolios: Change laws to permit unsecured loan portfolios to serve as collateral for accessing loans from the formal sector for refinancing.

Reform borrower status and the law: Reform laws relating to the status of borrowers with regard to age of majority, homestead, literacy, and civil registration. Facilitate the poor, illiterate, and young heads of households in legally conducting business with the formal sector, such as the signing of contracts, opening businesses, and borrowing.

Simplify bankruptcy procedures: Simplify and reduce the cost of bankruptcy procedures to have a simple and cheap exit mechanism for paying unsecured debt, recuperating lender funds, and returning remaining funds to the borrower.

Expand collateral use: Broaden the concept of security interest for immovable property, for example from land titles to land use rights. This effort requires recording economically important land use rights and employing legal mechanisms for transferring such rights.

Write public and commercial freehold and title registrations Create governing legislation for registration for property rights, including for movable assets. Credit registry and credit information bureaus should also be created.

Source: Fleisig and de la Peña 2003

Deficiencies in the enabling environment frequently limit the viability of financial service providers and therefore discourage financial services from spreading into rural areas and agriculture. Overcoming these deficiencies will require institutional strengthening in the broadest sense: strengthening of the judicial system, property registries, contracts and markets, infrastructure, and service providers.

Appropriate strategies for the poor. Within the agricultural sector, social groups have different financial (and nonfinancial) needs (box 8.6). Credit is suitable only in certain circumstances. For example, there is a significant difference between (1) financing a liquidity shortage for a viable activity and (2) giving money to people or enterprises that lack a viable business model (including farming) and may be unable to meet repayment commitments. The first may lead to poverty reduction and increased employment, and the second to an unsustainable debt burden. Microfinance has demonstrated that careful design of financial products and delivery mechanisms can allow those previously considered "unbankable" to be good clients. However, there are still cases in which credit is not suitable and grants may be more appropriate:

- Where the recipients are too poor to repay a loan, such as some groups of landless poor.
- Where the primary eligibility or targeting criterion is not "ability to pay" but rather membership in a certain target group (for example, credit to farmers to promote adoption of a certain technology).
- For a "lumpy" or long-term investment, or a risky start-up, neither of which fits a short-term, high-cost microloan.
- Where the recipient lacks the skills (or health) to make productive use of a loan.

Box 8.6 Categorizing the entrepreneurial poor and their financial needs

The "*entrepreneurial poor*" already engage in viable but low-productivity economic activities (including agricultural production or processing), or they have good investment opportunities but are constrained principally by lack of access to financing. This group includes farmers with access to sufficient land and inputs to consistently produce a surplus for marketing, and whose produce is in demand in accessible (local, national, or international) markets. Providing long-term working capital and appropriate training to these entrepreneurs contributes to the growth of their businesses and improves the potential for long-term viability.

The *very poor* have reasonable economic opportunities but are handicapped by low skills, poor basic economic infrastructure, lack of social capital, a remote location, and lack of financial institutions. This group includes farmers and agricultural businesses in marginal production areas, which are often distant from markets and poorly served by both public and private sector services. It may not be viable to provide financial services to poor people in these areas, and flexible, low-cost delivery mechanisms are needed. Savings may be more appropriate than credit for this group, and investments through grants may be necessary to increase the economic potential of such areas.

The *extreme poor* or destitute, especially in areas with low economic potential, are least likely to be well served by financial services but may require grant-based approaches to improve livelihoods.

Source: Authors

Where there is an element of entitlement or compensation in project design, credit (which is, of course, actually debt) is also not the appropriate tool. For example, if an amount of money is to be given automatically to individuals in a certain target group (such as refugees, HIV/AIDS sufferers, or retrenched workers), a grant should be used. Grants can take the form of start-up equipment for a farm or enterprise, a contribution to transition costs associated with adopting new activities, a grant (or food subsidy) to help a person move out of destitution or recover from an emergency, or a savings-type deposit that can be accessed later at a time of need (as opposed to a cash grant).

Access to flexible and safe savings facilities can enable poor households to reduce their vulnerability to shocks, save for expenses such as school fees, and can provide an important source of funds during the growing season. Transfer payment services, which facilitate access to remittance monies, are unaffected by agricultural production cycles and can provide important consumption smoothing and risk-reducing mechanisms for the poor. Credit is probably least suited to meeting the needs of the extreme poor, who have little likelihood of productive investment and credit repayment.

The success of microfinance in the past 20 years has led some to believe that the development of sustainable institutions providing financial services to the poor on a full cost-recovery basis is sufficient for poverty reduction. However, the causes of poverty are numerous and complex, and although microfinance is an important poverty-reduction tool, its effectiveness is linked closely to other interventions (and vice versa). Nonfinancial services can help the rural poor "graduate" to become suitable candidates for microcredit and other financial services, for example through building skills and capacities (health and education) and through improving access to markets. The starting point for operations in rural finance for agriculture must therefore be a research and consultative process to develop a solid understanding of the financial needs of the poor and of factors limiting their access to financial services.

Subsidies, credit lines, and guarantees. The revised OP 8.30 (World Bank, Operational Manual) clarifies the Bank's policy by stating the conditions under which subsidies and directed credits may be used. They can be used as part of an operation that aims to foster a market-oriented environment, which in turn enhances access of the poor and of small and micro enterprises to financial services. Market failures that result in poorly functioning and shallow agricultural financial markets may justify carefully designed subsidies, provided they are time-bound, used for overcoming those failures, and do not distort prices or target certain clients. Technical assistance, training, investment in systems, and other capacity-building subsidies can support the emergence of strong rural financial service providers. However, subsidies can also distort financial markets, inhibit the development of the financial system, and reduce the access of rural populations to financial services. These negative impacts result when subsidies are applied to prices (interest rate subsidies for the end borrower) or when credit is directed to certain groups or for certain purposes, without an overriding goal of creating sustainable financial institutions. Long-term or structural subsidies should also be avoided, because they can create dependence on donor funding. Sustainability in the provision of financial services

implies a transition to more commercial sources of funding over time, as donor funding is limited in size, temporary, and its availability is subject to policy changes.

Credit lines and guarantees can also distort markets and therefore should be used carefully—and only where parallel measures are taken to improve the operating environment for providing rural financial services.[2] Funding for lending portfolios may be justified in the short to medium term under the following conditions: if the financial institution is not able to take deposits (to avoid the risk of external funding undermining mobilization deposits), if sufficient capacity-building support has been successfully provided, and if commercial sources of finance (investors and banks) are not an option. In the longer term, however, both deposits and commercial sources of funds are more sustainable (and less distorting) sources of funds for intermediation than donor funding, and they do not expose the borrower to exchange rate risks (CGAP 2002).

Financial guarantees can be used to attract commercial financial intermediaries into lending to MFIs with an agricultural portfolio, or to develop financial credit within commodity marketing chains. Such guarantees should decline rapidly over time, and they should be designed to develop sustainable business relationships between providers and recipients by building trust and a good credit history. Guarantees are useful only if a substantial portion of the credit risk remains with the institution, to avoid moral hazard and to allow good credit practices to build up.

New Directions for Lending

Approaches are needed that expand the depth, scale, and outreach of financing for agriculture and that offer a wider range of better-designed financial services, provided at a lower cost and to poorer clients. Action is needed on two complementary fronts: improving the overall environment for the development of financial systems, and increasing the capacity of institutions to provide financial services to the agricultural sector.

Improving the environment for rural finance for agriculture. Creating a conducive policy framework for financing for agriculture is consistent with policies for improving the investment climate, supporting financial systems development, and increasing agricultural growth (Yaron, Benjamin, and Piprek 1997). The challenges of providing financial services to support the activities of small-scale farmers do merit particular emphasis on the following:

- Strengthening the capacity of land and property registries, and streamlining registration processes, to make collateral easier and cheaper to use and to promote secure land tenure and land-use rights. These actions will create an incentive for farm investment (for example, the modernization of the property registration system in

[2] OP 8.30 states that targeted lines of credit, when justified, should be accompanied by reforms to rectify underlying market imperfections. A Bank FIL may support directed credit programs to promote sustained financing for such sectors, provided the programs are accompanied by reforms to address the underlying institutional infrastructure problems and any market imperfections that inhibit the market-based flow of credit to these sectors. Such reforms include measures to (1) address obstacles that impede the flow of funds to the credit recipients or (2) enhance the creditworthiness of the intended beneficiaries through appropriate approaches such as mutual group guarantees.

Latvia during the Rural Development Project over 1997-2001 led to an eightfold increase in mortgage registrations).

- Ensuring that debtor rights do not outweigh creditor rights and building the capacity of rural courts to process claims efficiently and transparently.
- Eliminating any interest rate subsidies to agricultural lending through development banks or other institutions supported by government or donors.
- Investing in communications and physical infrastructure to reduce operating costs for financial service providers, and investing in education and health services to enhance the capacity of clients to take advantage of financial services.
- Reforming financial sector regulation and supervision (if needed) to promote the development of nonbank financial institutions. An example of such an institution would be a shareholder-based entity that is allowed to offer a limited range of financial services (such as credit, deposits, and domestic transfer payments) and that operates within a specialized regulatory framework and set of reporting requirements that do not restrict microfinance activities. This option may be necessary to encourage financial sector development and to enable product diversification beyond credit to deposit facilities and transfer payment services. However, this option should be considered only if there is sufficient will and resources to invest in building supervisory capacity to enforce the regulations. Poor people's money may otherwise be put at risk.[3]

Capacity development for rural finance for agriculture. Bank investment in financing for agriculture has long since moved away from channeling production credit through subsidized public-sector agricultural banks. It now recognizes the importance of building sustainable financial institutions that can provide longer-term access to financial services in rural areas. Funds for on-lending are of little beneficial use if the financial institution receiving them cannot use them effectively. Key areas for capacity building include:

- Investment in information systems that provide timely and accurate data to management.
- Training for staff, management, and board members.
- Strengthening internal controls and external monitoring, and improving the transparency and quality of external reporting.
- Assistance in designing and marketing a range of financial products and services.
- One-off grants to support innovations (for example, introducing new technology or a new loan product) or expansion into more marginalized rural areas.
- Building on existing infrastructure (such as post offices, state banks, retail stores, and traders) to provide a range of financial services at low cost and at scale.

[3] To enable rural financial service providers to take deposits from the general public, there may be a case for prudential regulation that is aimed at protecting the soundness of the financial system as well as depositors. Given its high cost, care should be taken to avoid using prudential regulation for nonprudential purposes (that is, the formation and creation of MFIs, preventing fraud and financial crimes). The introduction of new regulations often sets off unintended consequences (such as renewed enforcement of interest rate ceilings), and the costs of new regulation and its supervision have to be justified by a critical mass of qualifying institutions.

At present substantial Bank and donor funds lie unused in apexes (second-tier wholesale funds) intended for on-lending by agricultural and microfinance providers. For example, the Social Development Fund in Yemen had only 40 percent of its fund assets (US$5 million) allocated to MFI investments.[4] The absorptive capacity for apex funds is therefore limited by the size and expansion capacity of existing providers of financing for agriculture. Funds should be committed to apexes only if (1) sufficient absorption capacity exists for using the apex funds effectively, and/or (2) simultaneous investment in developing institutional capacity of existing providers is carried out. Well-designed support for capacity building requires the involvement of a financial sector specialist and need not be limited to direct providers of financial services: many other institutions can play a vital role, from credit bureaus and industry associations to rural producer organizations, community self-help groups, agribusiness development centers, and local NGOs. Without this capacity-building investment, the provision of financing for agriculture will occur only on a limited scale.

Innovation—new product development and delivery mechanisms. Improving the outreach and performance of rural finance for agriculture requires innovations and new or adapted financial products to overcome the challenges presented by agricultural activities and environments. Applying products and approaches that work in urban settings or for nonfarm activities has worked only for agricultural activities that have a similar income and risk profile as nonagricultural activities, such as egg production or greenhouse-based vegetable production. Rural finance for agriculture needs to match seasonal income cycles and term investment needs, manage risks, mobilize savings, develop lower cost operations, and cope with deficiencies in client information availability.

Diversification of loan portfolios over time and economic sectors, and product diversification toward savings, insurance, and leasing, can be effective risk management strategies. Savings-based approaches offer particular promise in more remote rural areas. New and promising products that help address the challenges posed by financing agricultural activities merit support for piloting. Innovation involves risk-taking on the part of the provider, and there is a legitimate role for donors to support innovation and provide the resources to scale up successful innovation for wider application. To improve the viability of rural financial services and lower their cost to clients, flexible delivery mechanisms are needed. Instead of investing in expensive branch networks, financial services could instead be made available through existing delivery outlets, such as an agricultural development bank, a rural post office, retail stores, or rented offices in schools and hospitals. If other financial institutions are present, branch facilities could be shared to lower operating costs. Mobile and automatic teller machine (ATM)-based delivery mechanisms are being piloted by several rural finance institutions and show significant potential for lowering the costs of providing rural financial service.

Capitalizing on existing institutions and infrastructure. If existing infrastructure and institutions are in place, they may be utilized where appropriate to improve financial services. There are advantages and cost savings from working through institutions that

[4] A more efficient apex is the Rural Finance Corporation of Moldova, which claims to have 100 percent of its fund assets (US$4.8 million) committed to MFI investments (MixMarket).

are already established in rural areas, though the choice of institution must be carefully considered. There are potentially significant benefits (and risks) of using established branch networks and client bases, provided that their use is combined with extensive reform of bank systems and management. Where the institutional commitment is lacking, or the costs of reforming and building the capacity of existing institutions or rehabilitating infrastructure are too great, starting from scratch may be best. MBFOs can build the capacity of existing community organizations, including, where appropriate, linking them to the formal financial sector.[5] In some circumstances, financial services may be best provided by organizations falling outside the traditional definition of a financial institution. For example, there is considerable potential for extending and improving sources of production credit for farmers by input suppliers, processors, and buyers.[6]

Scaling Up Investments

Donor or government monitoring of finance providers for agriculture should emphasize institutional performance and progress in institutional capacity, rather than activities and outputs. Experience has shown that investment in rural financial service providers produces superior results if program design, reporting, and monitoring focus on areas that are considered key for performance. Performance can be defined as the extent and efficiency with which providers reach their target groups. It is best measured jointly as outreach and sustainability. *Outreach* is a measure of the scale and depth of penetration of a rural financial service provider in relation to its target group, and *sustainability* is the ability of an institution to survive over the long term. Sustainability has ownership, governance, and management components as well as financial dimensions (box 8.7).

Tranched funding can be an effective means of enforcing performance targets, with the disbursement of subsequent tranches dependent on the achievement of minimum performance thresholds or targets. A business plan agreed to by the financial institution can provide key performance targets, and it can also form the basis for designing institution-building assistance. Capacity building of project implementers, as well as the financial service providers, can also be included within projects if appropriate.

[5] See the AIN, "Membership-Based Financial Organizations."

[6] See the AIN, "Production Credit from Input Suppliers, Processors, and Buyers."

The World Bank is in a strong position to influence borrowing governments and other donors. Through the following practical actions, the Bank can lead improvements in the quality and effectiveness with which financing for agriculture is scaled up:

Box 8.7 Minimum reporting indicators

All project phases (project appraisal, design, monitoring and reporting during implementation, final evaluation) should use appropriate measures of outreach and sustainability. Such indicators should include:

- *Number of clients that are being served:* measured by active clients or accounts.
- *Client poverty level:* through average outstanding loan or savings balance, as a percentage of GDP/capita.*
- *Performance in loan collection:* for example, portfolio at risk beyond a stated number of days.
- *Efficiency:* operating and/or lending costs as a percentage of the loan portfolio or assets.
- *Financial sustainability:* use return on assets and/or return on equity. For subsidized institutions, financial self-sufficiency, adjusted return on assets, and/or the subsidy dependency index can all be used to quantify the subsidy that is required/invested for a certain project outcome.

Sources: World Bank 2003; CGAP 2003
* This indicator may be less relevant for projects that promote financial services to larger agribusinesses.

- Incorporating financial expertise into the project team (whether through an in-house specialist or an outside consultant) for rural finance for agriculture projects, or for projects that include a component of finance to farmers or agriculture-dependent households.
- Considering rural finance for agriculture projects and components as falling under a wider financial systems approach, and not simply as a contribution to a narrow agriculture sector goal.
- Requiring financial service institutions to follow internationally accepted accounting standards and to practice full disclosure. Where indicators specific to microfinance are used, then standard definitions should be applied (CGAP 2003). External audits and ratings of rural finance for agriculture providers should be required as standard for more formal financial institutions. A professional appraisal of all financial institutions that on-lend bank loan funds should be encouraged. For smaller and less formal community-owned organizations, such appraisals may be too expensive, and other forms of reporting and monitoring should be used, consistent with full disclosure and accepted indicators.

Selected Readings

Asterisk (*) at the end of a reference indicates that it is available on the Web. See Appendix 1 for a full list of Websites.

CGAP (Consultative Group to Assist the Poor). 2001. "Disclosure Guidelines for Financial Reporting by Microfinance Institutions." Washington, DC: CGAP.*

FAO (Food and Agriculture Organization). 2003. "Term Finance in Agriculture: A Review of Relevant Experiences." Vols. 1 and 2. FAO Investment Centre Occasional Paper Series No. 14. Rome: FAO Technical Cooperation Department, Investment Centre Division, FAO/World Bank Cooperative Programme.

Fleisig, H. W., and N. de la Peña. 2003. "Legal and Regulatory Requirements for Effective Rural Financial Markets." Paper presented at Paving the Way Forward for Rural Finance: An International Conference

on Best Practices, sponsored by USAID and hosted by BASIS CRSP partner, World Council of Credit Unions, June 2-4, Washington, DC.*

Hollinger, F. 2003. "Financing Term Investments in Agriculture: A Review of International Experiences." Paper presented at Paving the Way Forward for Rural Finance: An International Conference on Best Practices, sponsored by USAID and hosted by BASIS CRSP partner, World Council of Credit Unions, June 2-4, Washington, DC.*

Yaron, J., M. P. Benjamin, and G. L. Piprek. 1997. *Rural Finance: Issues, Design, and Best Practices*. ESSD Studies and Monographs Series 14. Washington, DC: World Bank.*

References Cited

CGAP (Consultative Group to Assist the Poor). 2002. "Water, Water Everywhere, But Not a Drop to Drink." CGAP Donor Brief 3. Washington, DC: CGAP.

CGAP Consultative Group to Assist the Poor). 2003. "Microfinance Consensus Guidelines: Definitions of Selected Financial Terms, Ratios, and Adjustments for Microfinance." Washington, DC: CGAP and the World Bank Group.

FAO (Food and Agriculture Organization). 2003. "Term Finance in Agriculture: A Review of Relevant Experiences." Vols. 1 and 2. FAO Investment Centre Occasional Paper Series No. 14. Rome: FAO Technical Cooperation Department, Investment Centre Division, FAO/World Bank Cooperative Programme.

Fleisig, H., and N. de la Peña. 2003. "Legal and Regulatory Requirements for Effective Rural Financial Markets." Paper presented at Paving the Way Forward for Rural Finance: An International Conference on Best Practices, sponsored by USAID and hosted by BASIS CRSP partner, World Council of Credit Unions, June 2-4, Washington, DC.

IADB (Inter-American Development Bank). 2001. "Rural Finance Strategy." Sustainable Development Department Sector Strategy and Policy Papers Series. Washington, DC: IADB.

MixMarket. http://www.mixmarket.org/en/home_page.asp.

World Bank. Operational Manual. http://wbln0018.worldbank.org/institutional/manuals/opmanual.nsf/.

World Bank. 2003. "Rural Finance Services: Implementing the Bank's Strategy to Reach the Rural Poor." Report No. 26030. Agriculture and Rural Development Department, Rural Private Sector, Markets, Finance and Infrastructure Thematic Group. World Bank, Washington, DC.

Yaron, J., M. P. Benjamin, and G. L. Piprek. 1997. *Rural Finance: Issues, Design, and Best Practices*. ESSD Studies and Monographs Series 14. Washington, DC: World Bank.

This overview was written by Douglas Pearce (CGAP), Andrew Goodland, and Annabel Mulder, with researcher support from Amitabh Brar (CGAP) and Romeo Esangga, ARD. Peer reviewer comments were provided by Cornelis van der Meer, Carlos Cuevas, Honnae Kim, Renate Kloeppinger-Todd, William Steel, Jock Anderson, and Katrine Saito.

Microfinance Institutions Moving into Rural Finance for Agriculture

Microfinance institutions (MFIs) have tended to avoid less densely populated or diversified rural areas and the financing of seasonal or longer-term crop and livestock activities. A few innovative MFIs, however, recently have led the way in adapting their operations and products to expand into agricultural lending. They have done so by tailoring procedures and products to seasonal agricultural needs, applying risk management techniques, and adopting new technologies. Successful MFIs have important strengths, such as financial sustainability, excellent portfolio quality, financial products that fit diverse client needs, and a clear commitment and orientation to the poor. Prudent risk management techniques can increase the outreach of MFIs to less affluent, more remote rural areas and more diversified farmers.

Rural financial services have benefited significantly from treating the rural household as a unit with diverse activities and sources of income and financing, instead of maintaining a narrow focus on agricultural credit. Even so, financing for agriculture still tends to fall outside the scope of the mainstream microfinance industry. Where rural microfinance providers do exist, they are mostly limited to diversified rural economies and to clients with a number of income sources. Rural areas that are not densely populated, or that are dependent on a few principal crop and livestock activities, tend to be avoided by MFIs, because of higher transaction costs, price and yield risks, seasonality, and collateral limitations in the agricultural sector. Conventional microcredit relies heavily on short-term loans with frequent, regular repayments, a model that does not fit well with seasonal crop production or livestock production (except for poultry).

Involvement of Microfinance Institutions

Public investments can help microfinance providers meet the challenges of financing for agriculture by making adaptations to conventional financial products and delivery mechanisms, including the following:

Matching disbursement and repayment to agricultural production cycles. Flexibility in loan disbursement and repayment is needed, with finance made available when farmers need it and repayments matching income from produce sales. A rural MFI in Bolivia, PRODEM, redesigned its lending products by using market research to understand the financial service demands of agricultural clients (box 8.8).

Box 8.8 Bolivia: PRODEM—using market research to adapt lending methodology

PRODEM is one of the largest providers of rural financial services in Bolivia. It conducted donor-supported market research and product development to adapt its range of financial products to client needs, including the financing needs of small-scale farmers. A customized repayment scheme was introduced for small-scale farmers, with differing repayment schedules to fit harvest calendars even for members within a solidarity group. Individual agricultural loans were also introduced, with collateral at a ratio of 1.5:1 to the loan amount. PRODEM further minimizes risk by restricting final loan payments to a maximum of 60 percent of the loan amount, and by

limiting each office's portfolio in each economic sector to 30 percent. Money transfer, microleasing, and savings products were also designed. Agricultural lending now accounts for about one-fifth of PRODEM's loan portfolio.

Source: Lee 2000; Rubio 2003 (internal report prepared for CGAP)

Several other leading MFIs have also adapted their lending methodology to fit agricultural activities. For example, the agricultural loan products of Calpiá, an MFI in El Salvador, have been successful largely as a result of their flexibility in timing, amount disbursed, and repayment schedules. With regular bimonthly, trimester, semester, annual or even end-of-crop-cycle and irregular payment options, repayment schedules are sufficiently flexible to be attractive for a range of agricultural activities. Calpiá's agricultural lending still treats the farm household as a financial unit, basing lending decisions on overall repayment capacity.

Flexibility in collateral requirements. Land may hold little value as collateral, as land-use rights may be difficult to prove, clients may not own land, land markets may be weak, or the cost of registering land as collateral may be high. For these reasons, financial service providers need to be more flexible with regard to the collateral required, even if the value of nonmortgage guarantees is sometimes more significant as a repayment incentive than real resale value. Personal guarantees, movable assets, and group guarantees can all be adequate alternatives. Because it is time consuming and more expensive to get the notarization required for a mortgage guarantee, Centenary Rural Development Bank (CERUDEB) in Uganda also accepts livestock, personal guarantors, land without a title, household items, and business equipment. Since women may be disadvantaged by traditions of registering property in the husband's name, women tend to rely more heavily on their human capital for accessing loans (shown by women's greater participation in solidarity groups).

Using technology. Technological innovations can increase operational efficiency and reduce the costs of operating in rural areas, while improving the financial services available to rural clients. ATMs, point-of-sale machines, and smart/debit cards provide flexible payment options and more convenient access to client accounts. They can also reduce branch infrastructure and employee costs. A major advantage of their use in rural areas with poor infrastructure and communications is that financial transactions can be conducted entirely offline, with all account information stored in the chip.

Personal digital assistants (PDAs) can streamline loan officers' activities and speed decision making. The value of fast, in-the-field decisions can be enhanced by incorporating credit scoring into PDAs or hand-held computers, although credit scoring requires well-developed client information systems. ADEMI in the Dominican Republic has developed a credit scoring system linked to laptops and PDAs and estimates that it will substantially reduce loan disbursement time in rural areas.

Although the potential offered by new technologies is significant, experience has been mixed. There has been a tendency to overestimate the short-term benefits and underestimate the up-front implementation costs. In India, the Swayam Krishi Sangam's experiment combines smart cards with hand-held computers to streamline meetings

between clients and borrowers in remote areas, but this effort did not produce the dramatic time savings expected, and the project's expansion has been put on hold.

Flexible delivery mechanisms. By using existing delivery outlets rather than investing in expensive new branch networks, financial institutions can significantly lower the cost of providing services and can also provide a wider range of services. This strategy holds potential for reaching rural women, whose opportunity cost of engaging in financial transactions, owing to time constraints, not only involves lost income but also internal household substitutions (for example, child labor for adult female labor).

Options include working with/through rural post offices, retail stores, rented offices in schools and hospitals, or shared offices with other financial institutions. Mobile staff can help reduce operating costs and improve access in more remote areas. For example, Constanta, an MFI in Georgia, uses temporary "service points" (typically rented rooms in a bank branch) coordinated by nearby branch offices and linked to mobile loan officers. In Latvia, the Agricultural Finance Company used mobile credit officers to overcome transportation problems faced by farmers. This mobility also enabled loan officers to visit clients frequently and encourage loan repayment.

Risk management techniques. A principal factor discouraging MFI lending to small-scale farmers is the systemic risk inherent in much smallholder agriculture. Most MFIs that have successfully moved into agricultural lending have used a diversification strategy to reduce lending risk, both in their portfolio and at the household level.

Portfolio diversification helps ensure that a loan portfolio is diversified across sectors and regions/communities and those repayments do not fall due at the same time. Diversification increases the stability of the portfolio and reduces lending risk arising from weather events and from price fluctuations in certain crops. Confianza, a Peruvian MFI that developed from a purely agricultural portfolio, has now set a target percentage for agricultural lending of 30 percent of its overall portfolio. Uganda's CERUDEB, which reached out to rural areas from an urban base, set its upper limit at 25 percent. Household diversification is also important, because many MFIs that have developed a stable agricultural lending portfolio minimize risk by excluding households that rely on only one or perhaps two crops and have no off-farm income. Other risk management techniques include:

- Limiting the length of loans to agricultural smallholders. One drawback of this option is that it can preclude term finance, which is important for agricultural investments such as tree crops, erosion control, some livestock activities, and equipment and machinery.
- Testing a new rural market before investing in a branch office. This strategy reduces the risks involved in expanding rural finance outreach. Calpiá reduces the risk of establishing new rural branches by first building the portfolio from neighboring branches and conducting market studies of a new region. Rural branches are set up only if the portfolio size merits the investment in infrastructure and human capital.
- Purchasing hedging instruments on international markets. This option helps to manage potential losses from price or weather risk and allows greater confidence in

moving into agricultural lending, but it can be expensive and remains to be tested for MFIs.

Benefits

When MFI activity increases in more difficult rural areas and in financing agriculture, the results can include increased competition, higher volumes of finance, and a wider range of financial services for farmers and farm households. The rapidly growing agriculture portfolios of MFIs such as Bolivia's PRODEM and Caja los Andes, and El Salvador's Calpiá, suggests that there was significant unmet demand for financing for agriculture.

MFIs can offer credit not just for agriculture but also for nonfarm, household, and emergency needs, as well as savings and transfer payment services (if they are appropriately licensed). Increased competition between financial service providers operating in rural areas (such as product-market credit providers, moneylenders, and credit unions) can lead to more favorable and transparent terms of access for the poor. When MFIs comply with good practice, they can also bring a commitment to efficiency, transparency in reporting, high portfolio quality, and generate positive cash flows to finance growth, hence making rural finance sustainable.

Policy and Implementation Issues

Policy environment. Expansion by sustainable microfinance providers into financing for agriculture ultimately will be limited by underlying constraints arising from poor infrastructure, high-risk or low-return agriculture, deficient client information, poorly functioning property registries and markets, and policy biases/distortions. Improving the enabling environment for rural finance remains an urgent priority.

Services for the poor. Even MFIs that have expanded successfully into financing for agriculture have been limited mostly to farmers with diversified household incomes in less-remote areas. Portfolio diversification is a widely used risk management strategy, but it has the clear drawback, from a poverty reduction and market development perspective, of limiting access for poorer farmers from marginal rural areas. Other institutional models share this problem. Less formal, membership-based financial organizations may have a greater tolerance for operating in marginal areas, however, given their responsiveness to their members and their relatively low cost.

Term finance. Term finance is more costly and risky than short-term finance, because it ties up larger amounts of money for longer periods and requires the mobilization of long-term funding. It also requires more careful screening and selection of borrowers, which increases transaction costs. Term finance is best provided by competent financial institutions within a well-developed rural financial system, because increased attention is needed to maintain a good lender-borrower relationship over time, and techniques are needed to manage increased lending risks. More than half of the outstanding loans (which total US$5.6 billion) made by Thailand's BAAC, a large state-owned bank and one of the world's largest MFIs, reportedly have terms exceeding one year. BAAC uses donor and government funding and term deposits to supplement its commercial borrowings to

match its liability-asset structure. Longer-term donor funding can potentially address the funding constraint for term loans, but not the higher risk involved.

Liquidity management. Disbursements in several installments over a cropping period, repayments at harvest, and a lean time characterized by repeated requirements for cash, all present liquidity managements challenge to financial service providers. An institution's cash flow can become more cyclical, with suboptimal asset productivity. To improve the productivity of staff and assets, and to improve liquidity management, alternative financial products can be developed, such as nonseasonal loans for household needs and deposit facilities. In communities that are highly dependent on a few agricultural activities, however, the demand for these products will also be seasonal. Transfer payments from urban areas or from abroad do not follow the same seasonal patterns, and they can smooth demand for loans and facilitate repayment in periods of low agricultural income, as can savings deposits.

Lessons Learned

Principal lessons learned for supporting MFIs to move into agricultural finance are:

- Flexible disbursement and repayment schedules are keys to successful agricultural lending, although they may increase default risk and present liquidity management challenges.
- Diversification at the portfolio and client household levels can reduce the risk for MFIs that expand into financial services agriculture, but these strategies can also restrict access to services among farm households that depend on agriculture. Nonfinancial interventions to improve market access and infrastructure may make these clients more attractive in the longer term.
- Technology can help lower costs and expand rural finance operations, but first a careful cost-benefit analysis should be conducted, and the MFI's management information system (MIS) may need to be upgraded.

Recommendations for Practitioners

Recommendations for practitioners involved in MFI-related investments include (box 8.9):

- Plan feasibility studies, piloting, and market research to reduce the risks associated with moving into financing for agriculture and to enhance the usefulness of financial services to farmers.
- Assess the likely impact on the financial institution itself (for example, on cash flow, loan repayment, and staff productivity) of adapting loans to fit agricultural cycles.
- Focus on other financial services as well as credit, because access to remittance monies and deposit services can help clients (and MFIs) smooth seasonal income flows.
- Expansion costs (for example, setting up new rural branches) may merit funding support, but more cost-effective alternatives, such as sharing facilities with other financial or nonfinancial entities (post office, stores), should be explored first.

Box 8.9 Potential investments

- Funding for product design (not just loans but also savings facilities and transfer payments), including funds for market and client research, piloting new products, and staff orientation.
- Support for replicating proven approaches (for example, PRODEM in Bolivia or Calpiá in El Salvador) with other microfinance institutions (MFIs).
- Funding for piloting the adoption of technologies (examples include automated teller machines, personal digital assistants, and smart cards) and/or flexible delivery mechanisms (such as post offices, retail stores, and schools).
- Feasibility studies for helping MFIs in deciding to introduce new technology.
- Management information systems and equipment for their effective operation.
- Investment in a positive enabling environment to enhance the viability of rural finance for agriculture, through developing infrastructure, legal systems, and communications.
- Research and piloting of innovative sources of collateral for the agricultural sector, so that economically active poor people who are landless or lack assets can still qualify for loans.
- Nonfinancial support to farmers, through business development services, infrastructure improvements, and other means that will help clients become creditworthy.

Source: Authors

Selected Readings

Asterisk (*) at the end of a reference indicates that it is available on the Web. See Appendix 1 for a full list of Websites.

Campion, A., and S. S. Halpern. 2001. "Automating Microfinance: Experience from Latin America, Asia and Africa." Occasional Paper 5. MicroFinance Network, Washington, DC.

Navajas, S., and C. Gonzalez-Vega. 2000. "Innovative Approaches to Rural Lending: Financiera Calpiá in El Salvador." Economics and Sociology Occasional Paper 2571. Ohio State University, Columbus.*

Yaron, J., M. P. Benjamin, and G. L. Piprek. 1997. *Rural Finance: Issues, Design, and Best Practices*. ESSD Studies and Monographs Series 14. Washington, DC: World Bank.*

References Cited

Lee, N. 2000. *Client-Based Market Research: The Case of PRODEM*. Toronto: Calmeadow.

This investment note was written by Douglas Pearce (CGAP), Andrew Goodland, and Annabel Mulder, with researcher support from Amitabh Brar (CGAP).

Financial Services through State Banks

Networks of state banks or recently privatized state banks with large rural branch networks offer a mechanism for introducing low-cost financial services at scale, because frequently they are the only multiservice financial institutions with an extensive presence in rural areas. Technical assistance to improve management and training can help these institutions fill the gap in financial services for farmers and their households. That said, such support is recommended only if state bank managers and government owners (if any) are committed to following good practice. Given the long history of directed credit and undue political influence, unqualified support to state banks is not advisable. Also, when privatization is the goal, there is a danger that new owners will redirect the bank's focus away from serving poorer agricultural clients.

State-owned banks that may have extensive rural networks of branches or outlets include agricultural development banks, regional development banks, savings banks, and postal banks. This investment note is also relevant for privatized state banks with significant rural outreach, although often privatization has reduced their rural coverage.

Providing Financial Services

Specialized MFIs have tended to avoid clients who depend on agriculture or live in remote areas, primarily because of the risks inherent in agricultural lending and the cost of maintaining service points in sparsely populated rural areas characterized by cyclical demand. Other financial institutions that operate in rural areas, such as NGOs and credit unions, can offer only a limited range of financial services. They may be unable to supplement income from lending with income from transfer payment and deposit services.

Offering diverse financial services through existing banking infrastructure is more likely to be a viable strategy when the branch network runs efficiently and at low cost. There are increasing examples of financial services being offered successfully to rural populations through state banks, which have taken advantage of their existing branches, assets, customer bases, transfer and remittance services, operating systems, and banking licenses to lower initial and subsequent costs. The shortcomings of state banks are well known, however, and their vulnerability to political influence, associated with a tendency toward subsidized and/or directed credit,[7] has rightly made working with such banks unattractive for the World Bank and most donor agencies. This investment note does *not* advocate a return to either unqualified support to state banks or to lines of credit offered through state banks. Instead this investment note explores ways to build on, or take advantage of, their infrastructure, services, and systems to extend a range of viable, demand-driven, and low-cost financial services to agriculture-dependent populations and agribusinesses.

[7] The World Bank's OP and Bank Procedure (BP) 8.30 on Financial Intermediary Lending do not permit directed lines of credit and interest rate subsidies.

There are three main options for engaging with such banks: (1) a management-led turnaround of the bank; (2) the creation of a specialized unit that utilizes bank branches and systems; and (3) linkages with other financial service providers. The first option is the most ambitious, as it implies a complete reform of the bank. The second does not address the weaknesses of the entire bank. Rather it attempts to set up a subsidiary or department with sufficient operational independence to implement good practice micro- or rural finance through the existing rural branch infrastructure. The third option makes use of state banks without working through them directly.

Management-led bank turnaround. Management contracts supplemented by technical assistance produced the recent impressive turnarounds of two state banks: the National Microfinance Bank (NMB) of Tanzania (box 8.10) and the Agricultural Bank of Mongolia (AgBank) (box 8.11 and the IAP, "Mongolia: Technological Innovation Serving Rural Areas"). The respective governments used funding from the World Bank (in Tanzania) and USAID (in Mongolia) to contract a U.S. consulting firm to provide management and technical assistance over a period of at least two years.

Box 8.10 The National Microfinance Bank of Tanzania

The National Microfinance Bank (NMB) of Tanzania, with a rural branch network of 100 service points, was created in 1997 in a spin-off of assets of the state-owned National Bank of Commerce. The government contracted a U.S. consulting firm to place an external management team in the bank. Public confidence in the bank grew, as did deposit levels. New microloan products were researched and designed to develop a lending business, and the loan portfolio rose from zero to over US$4 million, with more than 10,000 loans (average loan size of US$400), including microenterprise and consumer loans. The number of branches has increased to 115 (43 of which offer loans), and performance has improved notably. NMB is now one of the most profitable banks in the country. In Fall 2005, NMB was privatized.

Source: Dressen, Dyer, and Northrip 2001

Box 8.11 Khan Bank of Mongolia

The Agricultural Bank of Mongolia (AgBank) was formed in 1991 out of the breakup of the State Bank of Mongolia, and by 1999, after several failed reform attempts, was in receivership. A U.S. consulting firm was contracted in 2000 to improve the viability of its existing rural branch network of 275 service points. AgBank has dramatically improved its profitability through management reform and the introduction of new products. AgBank invested in market research, leading to product development and then product marketing, to encourage clients' uptake of services. New loan and deposit products breathed life into previously underutilized branches. After losses of more than US$4 million in 1999, AgBank attained profitability in January 2001 and has been profitable ever since, while extending its rural business continuously. AgBank was privatized in early 2003 for US$6.8 million and renamed Khan Bank. It was named "Best Bank in Mongolia – 2006" as a leading financial institution in delivering innovative financial services to all Mongolians. The Bank was also chosen as the best bank in 2002 and 2003.

Source: Khan Bank 2005; Dressen, Dyer, and Northrip 2001

The objectives pursued under these contracts were to: (1) restore financial soundness to the bank; (2) add new financial services tailored to previously neglected yet attractive market segments; and (3) prepare the bank to operate independently. The contracts included the cost of temporary foreign senior management, intensive technical assistance, systems and infrastructure improvements, and new product development and marketing to diversify financial services and improve branch viability.

Specialized micro- or rural finance unit. Creation of a specialized financial service department or subsidiary within a state bank structure can help insulate the subsidiary from political influence and provide freedom to operate along the lines of internationally accepted good practice. The success of the local microfinance units (*unit desas*) within the state-owned Bank Rakyat in Indonesia, the world's largest sustainable microfinance provider, illustrates the potential of autonomous units within a state bank structure. CrediAmigo, an autonomous microfinance unit set up by Banco do Nordeste, a regional Brazilian development bank, is a more recent example (box 8.12).

Box 8.12 Brazil: Banco do Nordeste

In 1995, the new president of Banco do Nordeste implemented a reform of the bank and contacted the World Bank about developing a microfinance program. The bank had 176 branches throughout the northeast, and it was willing to adopt good microfinance practices (for example, interest rates that fully covered costs, along with a commitment to high levels of loan recovery) and invest in the training, information, and operating systems needed for microfinance. Preparation and rollout took several years, but the results have been impressive. With more than 100,000 active clients and an outstanding loan portfolio of more than US$24 million, CrediAmigo, an autonomous microfinance unit in Banco do Nordeste, is now one of Latin America's largest microfinance providers.

During a pilot stage, Banco do Nordeste secured high quality international expertise (through a leading microfinance NGO) and learned from the microfinance experience in other countries through management study tours. After CrediAmigo was initiated as a pilot in five branches, the World Bank arranged a US$900,000 Japanese government grant to fund systems development and further technical assistance. When it became clear that Banco do Nordeste was ready to scale up safely and effectively, a US$50 million World Bank loan to support expansion was finalized in 2000.

Source: Schonberger and Christen 2001

Linkages with other financial services providers. Arrangements that allow specialized financial service providers to take advantage of the infrastructure, staff, and systems of state, savings, and postal banks can improve access to diverse financial services for agriculturally dependent populations. An agreement with a postal savings bank, for example, may allow a financial institution to provide money transfer services. Microfinance NGOs that are not allowed to offer deposit services may be able to negotiate access to savings schemes for clients through state banks. For example, the Senegalese Postal Savings Bank began offering deposit services to client groups of microfinance NGOs in 1995. Small rural credit unions can also benefit from state banks by using them as a safe place to store their excess funds. Donors may support such linkages by providing funding for harmonizing systems and procedures, management

information systems, improving transfer payment systems, technical assistance for microfinance product design, and training for staff involved in the linkage arrangements.

Benefits

Improving the quality, efficiency, and range of financial services on offer through rural branches of state banks serves the diverse financial needs of rural populations at scale. Because adding new financial products to an existing network and product range can be cheaper than investing in and maintaining specialized infrastructure, financial services can become available at a lower cost for end users.

A full management-led turnaround of a state bank is the most ambitious and costly approach presented in this investment note. The management contract for AgBank in Mongolia was almost US$3 million. Other donors such as GTZ also provided at least US$2 million in direct technical assistance and training. This approach can seem costly, yet it appears more reasonable when compared with either the eventual privatization proceeds (US$6.8 million) or AgBank's loan portfolio (US$25 million). For Tanzania's NMB, this simple cost-benefit comparison is less favorable. The overall contract was US$7 million compared to NMB's smaller portfolio of US$4 million, but NMB offers a wide array of deposit products and has disbursed more than 21,000 loans. Moreover, both banks have been transformed from cash drains to profit-making institutions. In the case of Brazil's Banco do Nordeste, less than US$1.4 million in grant-based technical assistance yielded a sustainable program with more than 100,000 active clients.

Policy and Implementation Issues

Credit for agriculture. There is no guarantee that small-scale farmers will be able to access financial products designed for *agricultural* activities. Neither CrediAmigo nor NMB has moved into agricultural lending on any scale. Banks need to take rational decisions about the relative risk and return from agricultural lending compared to other financial services and they should not be forced into directed agricultural lending. An important first step is to ensure that a bank has the management capacity, systems, procedures, and product development skills to expand into product areas such as agricultural lending. Parallel initiatives to improve the policy and operating environment for rural finance for agriculture and the risk profile of agricultural activities can improve the perceived attractiveness of financing agriculture. BAAC, the reformed agricultural development bank in Thailand, illustrates the potential of state banks in agriculture, as more than 90 percent of the loans to its 5 million borrowers are for agricultural activities.

Privatization. If privatization is an eventual goal for a state bank under a management turnaround contract, it may be necessary to provide continued support beyond the length of that contract to ensure that improved performance is sustained over the longer term. Achieving profitability is an important first step, as commercial owners are unlikely to close profit-making product lines and branches. Mongolia's AgBank will be a test case of the management turnaround approach and of whether it makes sense to improve branch viability rather than simply close branches. The same U.S. consulting firm hired to make

the bank profitable was awarded an ongoing management contract by the new owners, which is a positive indication of intent.

Lessons Learned

The following conditions are critical for success in working with state banks to implement either a management-led turnaround or a specialized unit/department. Where these conditions do not exist, the alternative of facilitating inter-institutional linkage arrangements should be considered, with contractual arrangements designed to hold the state bank to minimum relevant standards of good practice.

Commitment to good practice financial services. The government, board, and management of the state bank must agree to introduce sound financial service practices and refrain from exerting political influence on bank decisions. Good practice includes strict loan repayment, separate staff incentive and monitoring systems, full-cost interest rates, and appropriate reporting and portfolio management practices. The case of BAAC illustrates the danger of not having a clear separation from government influence (box 8.13).

Box 8.13 Thailand: reformed agricultural development bank (BAAC)

By virtue of its enormous outreach, BAAC—which counts 86 percent of farming households in Thailand as its clients—is a good example of a reformed agricultural development bank. In 2001, BAAC had more than 5 million borrowers, a total portfolio outstanding of US$5.7 billion, and deposits totalling US$5 billion. A debt-suspension program was initiated in 2001, giving participating farmers two options. Under a debt moratorium, no interest or principal would be due until 2004, but participants would not be eligible for any new loans. Alternatively, under a debt reduction option, farmers who continued to repay loans would receive a portion of their interest payments from the government and remain eligible for future loans. So far, 1.1 million clients (representing 21 percent of total portfolio) have enrolled under the debt moratorium scheme and one million (14 percent of the portfolio) have enrolled in the debt reduction scheme. This high level of loan reprogramming could cause BAAC serious repayment problems and undermine its culture of high repayment.

Source: CGAP internal documents

Demand for new financial services. Because there is little competition from other financial service providers offering deposit and transfer payment services in rural areas, lack of demand is unlikely to be a constraint, except perhaps in remote, underpopulated areas.

Commitment to long-term engagement. Donors, as well as state banks and governments, must take a long term view of reforms. In Banco do Nordeste's CrediAmigo program, an initial pilot provided important lessons for subsequent scaling up, and a World Bank loan was not approved until almost five years after initial contacts were made.

Recommendations for Practitioners

- Consider working with state banks only if there is sufficient long-term protection from government influence. The experience of Thailand's BAAC illustrates the risk of political decisions influencing bank policies.
- Be prepared for substantial technical assistance and systems investment. Funding will likely be needed to update systems, improve procedures, improve external public image, enhance customer service, and train staff. Such investment is critical to success and should not be seen as optional. If suitable funding is not available, the less ambitious linkage option should be considered (box 8.14).
- Proceed ambitiously but cautiously. Banco do Nordeste decided to scale up the CrediAmigo pilot program too early and too fast, expanding from five branches to 50 and increasing its client base to 100,000 within the first year of operation. The resulting heavy loan losses led to a temporary slowdown in expansion and an intensive loan recovery program.
- Support the development and introduction of new financial products. Market research linked to product design and piloting can result in products that better suit the diverse financial needs of rural clients, that are appropriately priced, and that lead to increased client uptake and branch transaction volumes.

Box 8.14 Potential investments

- New senior management to reform the bank.
- Technical assistance to introduce new lending instruments and systems.
- Infrastructure improvements.
- New product development and marketing.
- Funding to improve and harmonize systems, procedures, and reporting.
- Training and orientation for staff and management of the institutions.

Source: Authors

Selected Readings

Asterisk (*) at the end of a reference indicates that it is available on the Web. See Appendix 1 for a full list of Websites.

Dressen, R., J. Dyer, and Z. Northrip. 2001. "Turning Around State-Owned Banks in Underserved Markets." *Small Enterprise Development* 13(4): 58-67.

Grashof, L. 2002. *Country Case Study: Agricultural Bank of Mongolia*. Eschborn: Deutsche Gesellschaft für Technische Zusammenarbeit (GTZ).*

Kamewe, H. T., and I. A. Radcliffe. 2000. "Reviving Postal Savings Banks in East Africa." New York*:* United Nations Development Program (UNDP).*

References Cited

Dressen, R., J. Dyer, and Z. Northrip. 2001. "Turning Around State-Owned Banks in Underserved Markets." *Small Enterprise Development* 13(4): 58-67.

Khan Bank. 2005. *Annual Report.* Ulaanbata: Khan Bank. http://www.khanbank.com/adminaa/report/2005en1.pdf

Schonberger, S. N., and R. P. Christen. 2001. "A Multilateral Donor Triumphs over Disbursement Pressure: The Story of Microfinance at Banco do Nordeste in Brazil." CGAP Focus Note 23. Washington, DC: Consultative Group to Assist the Poor (CGAP).

World Bank. Operational Manual. http://wbln0018.worldbank.org/institutional/manuals/opmanual.nsf/.

This investment note was written by Douglas Pearce (CGAP), with extensive reference to documents and authors cited in the "References Cited" section.

Production Credit from Input Suppliers, Processors, and Buyers

Private firms, such as input suppliers and product buyers and processors, supply a sizable portion of farmers' credit needs. The provision of credit fits naturally with established business relationships, facilitated by good mutual knowledge, while collateral constraints are limited by linking credit with nonfinancial services. This investment note highlights the largely unexploited potential of supporting these arrangements by improving the development of producer associations, brokering contractual linkages between farmers and private businesses, and developing linkages with specialized financial institutions. Support in this area must proceed with caution, however, given limited project experience and thus limited knowledge about good practice. The risks of moral hazard are high, especially where contract enforcement is weak. There are also dangers of distorting input and output markets.

Agricultural commodity systems in developing countries frequently are characterized by financial transactions that serve as an important source of financial services for market participants in the absence of, or in addition to, institutional sources.[8] Although these financial transactions are largely independent of government and donor support and influence, and although they fall outside the formal financial sector, they are often vital for farmers to obtain inputs and bridge periods of low income prior to harvest. Usually on the basis of securing access to a farmer's produce, processors or buyers provide inputs on credit (usually in kind), often supplemented with technical advice to ensure quality standards are met, and guaranteeing a market for the produce. The repayment of the credit (and interest, if charged) is deducted when a farmer's produce is sold.

Because these trading arrangements fall outside formally regulated financial systems, farmers are vulnerable, and the true cost of credit is difficult to ascertain. Smaller-scale and more marginal farmers are particularly at risk, because often they have limited access to market information, low bargaining power, and weak business relationships with credit providers. Successful models have evolved, however, that create clear win-win outcomes for farmers and private credit providers. These models have included smaller-scale farmers, often through producer groups (box 8.15). Governments and donors can increase the outreach of production credit from input suppliers, processors, and buyers by (1) developing producer associations to enable small-scale and marginal farmers to engage with agribusinesses; (2) facilitating market brokerage between farmers and agribusiness; and (3) supporting linkages with financial institutions to improve the efficiency and transparency of credit.

[8] In El Salvador, for example, almost one-half of the rural people who access credit from sources other than family and friends do so from private sector suppliers rather than MFIs or banks (Buchenau and Hidalgo 2002). Four out of every five rice mills surveyed by FAO in India provided advance payments for inputs to farmers, accounting for about one-half of the total value of the crop (Shepherd 2003). In Zimbabwe the number of smallholders receiving input loans from the Cotton Company of Zimbabwe exceeds the total number of clients of formal MFIs in the country (Gordon and Goodland 2000).

Box 8.15 Cotton Company of Zimbabwe

In 1996, loan proceeds under the World Bank Agricultural Credit and Export Promotion Project were reallocated to establish a credit scheme for the Cotton Company of Zimbabwe (Cottco) to provide inputs to small-scale farmers. Credit is extended to farmer groups with joint liability, and services (including extension advice) are provided by the company.

Since its inception, the scheme has consistently reached over 50,000 smallholders each season, with repayment rates in excess of 98 percent. The scheme has helped farmers obtain increased yields and higher grades, with average smallholder yields increasing to 900 kilograms per hectare, compared to the national average of 700 kilograms per hectare. The scheme has captured the loyalty of producers, but competitors complain of the competitive advantage provided to Cottco by concessional financing from the government. As of 2003, there is only one other competitor in the sector, and Cottco has an 80 percent market share.

Source: Gordon and Goodland 2000; Poulton et al.

Development of producer associations for smaller-scale and more marginal farmers. Producer associations or groups can link small-scale farmers to market systems and credit sources (box 8.16). Producer associations address the following constraints encountered by processors and other buyers in dealing with small-scale farmers:

- Producer associations reduce the transaction costs resulting from having to distribute inputs to, collect crops from, and monitor and keep records on many scattered, individual farmers.
- They mitigate unacceptable levels of lending risk resulting from high levels of side-selling (to buyers other than those who provided the inputs). This situation is exacerbated by inadequate contract enforcement, but it can be addressed by establishing joint group liability.
- They increase the efficiency of providing the technical support services needed for the quality and quantity of production to meet buyers' requirements.

Box 8.16 Mozambique: producer associations linked to processors and exporters

V&M Grain Company is a leading domestic agribusiness in Mozambique. V&M offers interest-free advances to small- and large-scale traders as well as to umbrella groups of producer associations. An overall repayment rate of 98 percent is reported. Advances to producer associations are based on 50 percent of the value of crops at an agreed price, with no other collateral arrangements, and are provided for up to 20 days. The umbrella groups use a portion of the advance to transport their collected produce to a warehouse, and the rest is distributed downwards to producer associations who further distribute them to their producer members. Loans average between US$5,000 and US$10,000. Approximately 10 percent of the overall value of trade is reportedly lost in side-sales, in which the advance is taken from V&M but goods are sold to someone else.

Source: de Vletter 2003 (internal report prepared for CGAP)

Brokering market linkages. The starting point for any credit-based relationship between product market participants is the development of a business relationship. Such relationships can take some time and cost to foster, and they require initial networks or contacts, thus excluding many smaller-scale and more marginal farmers. There is a

legitimate role for a third party to broker business relationships to reduce initial transaction costs, and there have been successful experiences in relying on local NGOs (such as FAIDA in Tanzania; see box 8.17), ministries of agriculture (such as the Department of Agrarian Reform in the Philippines), or parastatal agribusiness development centers (for example ZATAC in Zambia) to do so. The scope of these "broker" technical assistance activities has included the formation and capacity building of producer groups; market matching (introducing farmers to potential business partners, such as agroprocessors; and facilitating the negotiation of contracts between farmers and business partners.

Box 8.17 Tanzania: FAIDA

In a typical FAIDA market linkage scheme, farmers receive inputs (seed, fertilizer), extension services, and a small loan from a company, while being assured they can sell their produce to the same firm. To minimize costs, the distribution of inputs, delivery of extension services, and the collection of produce are organized through farmer groups. The facilitator from FAIDA assists groups of farmers to organize themselves. Normally farmers open a group savings account, which serves as collateral for the inputs and the loans from the company. FAIDA can help the company access additional credit sources to finance the scheme, thereby ensuring that the collaboration is fair to both parties and results in a clear "win-win" situation.

Source: FAIDA

Linkage arrangements with financial institutions. Financial institutions specialize in providing financial services, whereas traders and processors usually lack the expertise and systems to do this effectively. By unbundling credit from input supply transactions, credit products can be made more transparent and efficient, with explicit interest rates and terms, thus allowing for competition and farmer choice to improve credit product design. Financial institutions can provide credit to farmers either directly in monetary form or through input suppliers in kind. Risk, information, and operating cost constraints remain for financial institutions entering agricultural lending. Financial institutions benefit from maintaining links to processors, traders, and other market system actors, which lower their costs and risks by ensuring that their farmer clients have a sales outlet, access to inputs, and appropriate product and technical advice (box 8.18). Unbundling credit from the sale of farm produce can result in traders or processors losing an important mechanism for securing supply, however. Before intervening in this area, donors need to be aware of the economic and social contexts in which informal transactions have evolved.

Box 8.18 Peru: linkage arrangements

Critecnia is a firm that works with small-scale cotton farmers in Peru. The farmers sign a management contract with Critecnia, which buys and markets their produce and provides inputs relatively cheaply. Prior to Critecnia's involvement, poor repayment by farmers was endemic, and financial institutions were wary of financing them. Critecnia now negotiates loans on behalf of the farmers, with the farmers providing land guarantees. Critecnia subtracts loan payments and fees for technical assistance and management at point of sale, and then splits net profits equally with farmers. Critecnia is reportedly profitable, with high repayment rates in most years.

Source: Wenner 2001

Benefits

In post-liberalized economies, with state withdrawal from input supply and marketing of outputs, facilitating production credit from private sources benefits various stakeholders:

- Small-scale and marginal farmers increase their access to domestic and international markets and to private input suppliers.
- Smallholder farm productivity is increased through the improved access to inputs, often supported by privately provided extension (as an "embedded" market service).
- Agribusiness development is stimulated through secured access to raw materials and greater influence over production processes (quality and food safety are important for access to international markets).

Policy and Implementation Issues

Avoiding market distortions. A central dilemma for the World Bank and donors is how to support the extension and development of financial services to small-scale farmers without distorting already-functioning product market systems. Providing financial support to specific companies to enable them to establish or extend credit can be beneficial to smallholders in the short term, but it may give the chosen company a market advantage and hurt competition.

Choice of implementation partner. The choice of approach, and the selection of implementation partners by a borrowing government, will depend on local circumstances and in particular on the capacity of local institutions. Evidence of commitment to servicing the smallholder sector is an important prerequisite.

Market and financial system development. The suitability of producer credit will depend partly on the level of market development and financial systems development. Where these are strong, it may be preferable to support the provision of producer credit through financial institutions, even though credit through private market participants may persist, in competition with financial institutions, to secure access to farmers' produce. Before supporting these approaches, it is also necessary that market development is at a sufficient level for inputs and outputs to be traded freely, and that financial systems can provide funds to processors and buyers to on-lend to producers.

Lessons Learned

Producer credit schemes can succeed even where contract enforcement systems are weak, though success requires overcoming the challenge of default, which is often associated with side-selling. The most successful producer credit schemes have used a combination of mechanisms to reduce default, including group liability, incentives for developing strong business relationships (such as the provision of further services), close monitoring, and rewards for prompt repayment.

The choice of crop is also important. As a general rule, suitable crops are nonfood cash crops (cotton, tobacco) and high-value horticultural crops. Common characteristics are crops that require high levels of inputs and/or technical knowledge, which farmers would find difficult to access in the absence of input credit schemes; the lack of alternative markets; and crops requiring specialized post-harvest activities—such as packaging, processing, and export—often with specific fixed investment assets, such as milling plants.

Working with partners to develop linkages between financial and nonfinancial actors and to promote producer associations requires substantial technical assistance and capacity-building investments. Other donors may in some cases be better placed than the Bank to provide this support, although the Bank could provide complementary support to improve the operating environment for rural finance institutions and for agribusiness.

Recommendations for Practitioners

Despite the potential for reaching many producers through this type of producer credit, donors and governments must proceed with caution to avoid introducing market distortions and disrupting existing informal financial services. Interventions and investments should be based on (box 8.19):

- An analysis of marketing systems and an assessment of the competence and commitment of the private sector to engage in production credit, as an important first step to understanding options.
- Focused support to groups of farmers and/or geographical areas that are not presently well integrated into product markets, thus helping develop/extend markets.
- Designing any subsidies (grants, technical assistance, training) to build capacity, not to subsidize costs or price of services or loans provided to farmers, and with a plan for eventual reduction and phase-out over time.
- Making support available through transparent selection criteria, with access open to more than one partner (be it a financial institution, NGO, or processor), and with continued support dependent on the achievement of agreed performance targets.

Box 8.19 Potential investments

Direct public (and donor) investment needs are limited, because market-provided production credit is delivered through private firms and individuals. However, public investment can provide:

- Support for development and strengthening of producer organizations.
- Capacity building for institutions providing a brokering role for business relationships between small-scale farmers (and producer groups) and agribusinesses.
- Market facilitation and information.
- Training and technical assistance on marketing and credit program management.
- An environment for the emergence of strong agricultural markets.

Source: Authors

Selected Readings

Asterisk (*) at the end of a reference indicates that it is available on the Web. See Appendix 1 for a full list of Websites.

Dorward, A., J. Kydd, and C. Poulton (eds.). 1998. *Smallholder Cash Crop Production under Market Liberalisation: A New Institutional Economics Perspective.* Wallingford: CABI Publishing.

Eaton, C., and A. Shepherd. 2001. "Contract Farming: Partnerships for Growth: A Guide." FAO Agricultural Services Bulletin 145. Rome: Food and Agriculture Organization (FAO).*

FAIDA. http://www.faida.or.tz.

Pearce, D. 2003. "Buyer and Supplier Credit to Farmers: Do Donors have a Role to Play?" Paper presented at Paving the Way Forward for Rural Finance: An International Conference on Best Practices, sponsored by USAID and hosted by BASIS CRSP partner, World Council of Credit Unions, June 2-4, Washington, DC.*

Phillips, R., and A. Serrano. 2000. "Case Study: Developing Self-Managed Outgrower Capacity in Zambia and Mozambique." Paper presented at the Rural Capacity Building and Poverty Reduction Workshop, sponsored by the World Bank's AKIS thematic group, June 28-30, Washington, DC.*

References Cited

Buchenau, J., and A. Hidalgo. 2002. "Servicios financieros privados en el área rural de América Latina: Situación y Perspectivas." Fortaleza, Brazil: Banco Interamericano de Desarrollo (BID), Departamento de Desarrollo Sostenible.

FAIDA. http://www.faida.or.tz.

Gordon, A., and A. Goodland. 2000. "Production Credit for African Small-holders: Conditions for Private Provision." *Savings and Development* 1: 55-84.

Poulton, C., J. Kydd, A. Osorio, D. Tschirley, W. Maro, M. Nylandsted Larsen, B. Zulu, B. Hanyani-Mlambo. Competition and Coordination in Cotton Market Systems in Southern and Eastern Africa. Imperial College of Science, Technology and Medicine. Agrarian Development - Research Projects. http://www.wye.ic.ac.uk/AgEcon/ADU/research/projects/cottonE/.

Shepherd, A. 2003. "Financing of Agricultural Marketing – Case Studies from Asia." Rome: Food and Agriculture Organization (FAO).

Wenner M. 2001. "Making Rural Finance Work." *Micro-enterprise Development Review* 3(2): 1-4. Washington, DC: Inter-American Development Bank (IADB).

This investment note was written by Andrew Goodland and Douglas Pearce (CGAP).

Membership-Based Financial Organizations

Support to membership-based financial organizations, including relatively formal credit unions, savings and credit cooperatives, and less formal community-based savings and loan associations, has had mixed results. In some cases, sustainable institutions have resulted, successfully reducing transaction costs and collateral constraints. In others, donor support has created dependence and failed to address problems of weak governance, poor internal control, and capture by elites. This investment note describes lessons learned and good practice in supporting membership-based organizations that provide rural financial services for agriculture. Support to such organizations is recommended where rural financial markets are underdeveloped but social, geographic, and economic conditions nevertheless create a comparative advantage for this low-cost approach.

Membership-based financial organizations (MBFOs) are important long-term sources of financial services in rural areas. Credit unions and savings and loan cooperatives are the leading sources of financial services to the poor in Latin America and in Central and Eastern Europe, and they are found worldwide. The performance of MBFOs has varied greatly, however, with problems arising from weak governance, poor internal control, donor dependence, and—for those institutions focused on agriculture—covariant risks.

The term "membership-based organization" refers to a range of organizations that are *member-owned and -controlled*, with membership defined either geographically (a community) or by activity (farmer cooperatives). More formal membership-based organizations include savings and loans cooperatives and credit unions, whereas village-based savings and loan associations can be much more informal. The degree of formality depends on such factors as scale, resources, level of systems development, financial product range, management capacity, and level of legal recognition. This investment note covers only those institutions with a primary focus on financial service provision, not multiservice organizations with nonfinancial aims.[9]

Less formal MBFOs are low cost, relying on primary low-level institutional systems and infrastructure, and local, often volunteer, staff. They can therefore operate in less-favored rural areas that are underserved or not served by banks and formal MFIs. Their ability to access local information on potential borrowers lowers the transaction costs associated with screening and monitoring. Their membership-based nature can provide useful peer pressure in enforcing loan contracts. They often suffer from weak internal controls and monitoring, however, and they may be susceptible to deterioration in portfolio quality, capture by well-educated/influential persons, and even fraud. Some MBFOs are run for the benefit of a few members, who monopolize access to loans, or alternatively give loans to members as a "right," with loan amounts simply multiples of member savings or shares. More formal MBFOs, such as savings and loans cooperatives registered with

[9] This investment note does not discuss community-based organizations that engage in financial services as their secondary or tertiary activity, such as churches, welfare, and development associations, or purely *informal* associations such as ROSCAs and CARE's Village Savings and Loan Model. These approaches will be discussed in a forthcoming Micro and Rural Finance Operational Note.

authorities that supervise financial institutions, are more protected from these weaknesses but have higher cost structures and are less suited to more marginal rural areas.

Support to MBFOs can be directed at four levels: the retail level, the wholesale or second-tier level, support institutions, and the policy and operating environment. All levels may need to be addressed, although not necessarily in a single project.

Retail level. Capacity building and technical assistance for MBFOs may need to focus on: loan analysis techniques, delinquency control, product pricing, loan loss provisioning, sufficiency of institutional capital, maintenance of adequate reserves, and proper asset/liability management. If financial product ranges are too narrow, product development may be necessary—for example, loan products may be designed for crop production, or deposit services designed for agricultural traders.

Wholesale or second-tier level. Capacity building can strengthen or create federations or networks that provide services to better enable members to: negotiate funds from banks or donors; represent member interests at the regional and national levels; develop common procedures and products; improve the marketing/branding of the organization; monitor performance; and provide a refinancing facility to meet members' short-term liquidity needs. The SICREDI system in Brazil, for example, depends on a well-functioning second-tier structure (box 8.20).

Box 8.20 Brazil: agriculturally oriented rural credit unions (SICREDI)

SICREDI is a savings and loan cooperative/credit union model that serves the needs of small-scale farmers and their households and has the following characteristics: savings-first, membership based on a common bond, member ownership, and equal voting rights. SICREDI is now the largest savings-based, member-owned credit union system in Brazil, with membership based on agricultural communities. As of December 2002, SICREDI had US$518 million in savings and outstanding loans of US$315 million.

SICREDI is composed of 767 agencies joined in 129 Credit Unions, which are audited and refinanced by the National Development Bank. The SICREDI Council develops policies and products and provides training services. Factors in the success of the SICREDI system include: use of consistent lending practices, system-level management of liquidity risk, and systemwide commitment to uniform standards. To use the SICREDI name and logo, credit unions must pass financial and product quality standards and meet specified policy criteria.

Source: Brian Branch, personal communication; DGRV

Support institutions. Investment is needed to strengthen or create low-cost service providers in such areas as bookkeeping, technical assistance, external audits, or product design. Because needs for technical assistance extend beyond the lifetime of most donor interventions, providers that can charge MBFOs fees for their services are more sustainable than continued reliance on subsidies.

Policy and operating environment. Work with government and other stakeholders to improve the policy framework and operating environment for MBFOs may involve legal reform, removal of interest rate caps, and investment in infrastructure and services.

Benefits

MBFOs can operate effectively in situations and with clients that banks view as unattractive, because they are primarily concerned with providing access to financial services for their members, not maximizing profits. Less formal MBFOs, such as savings and credit associations, are particularly well suited to more remote and poor rural areas, given their reliance on (often voluntary or part-time) local staff and management, a narrow product range, group and personal guarantees, and client information provided by the community. Investment in community-based MBFOs can contribute to local empowerment. Local ownership also ensures the social and cultural sustainability of the organization.

MBFOs can be more responsive to member needs than other financial institutions. Some have designed loan products to fit agricultural activities or offered financial products tailored to member needs (box 8.21). They can base product design on agricultural cycles, convenience of payments, and financial needs of different farming activities. However, to do this, the MBFOs need a basic level of product design expertise and systems to cope with more complex financial products. Technical assistance can be valuable in this regard, as long as the product range remains consistent with staff and systems capacity.

Box 8.21 Mali: village-based savings and credit associations

Village-based savings and credit organizations (CVECAs) are prevalent in parts of West Africa and survive even in remote areas. The Niono region of Mali has a network of CVECAs with over 9,000 active borrowers and savers. It is financially sustainable overall, with good reported portfolio quality. CVECAs are organized into a network, which borrows from an apex bank and on-lends money to the CVECAs. Loan funds are also generated from member savings. A fee-based auditing and training service provides ongoing support functions.

The highly decentralized structure of the network results in more efficient decision making and lower operational costs—each village determines its own interest rates and loan products. This feature helps financial products to fit seasonal agricultural cycles. Costs are also kept low by collaborating with the village farmer association for client appraisals, loan guarantees, and repayments.

Source: Chao-Beroff 1999; Ouattara, González-Vega, and Graham 1999

Policy and Implementation Issues

Member ownership. MBFOs depend on members exercising influence over the management of their institutions to reduce delinquency and risk of fraud. However, the fact that voting rights are distributed equally among members can weaken the monitoring function and make institutions vulnerable to dominant chairpersons and management.

Dependency. Donors must be careful not to create dependency. A donor can undermine MBFOs by pushing them to grow too fast or by providing too much external funding relative to internal member funds. One option is to limit any funding offered to an amount equal to the community's own contribution, particularly when financing a loan

portfolio. Funds can be matched to levels of member savings plus share contributions. Some specialists recommend that no external funds be provided for on-lending.

Strengthening versus creating MBFOs. Where MBFOs do not exist, as in some former republics of the Soviet Union, they have been created from scratch. This effort has had mixed results, and it is not recommended because it risks creating dependence on external support. For the governance structure of an MBFO to be effective, members must have and exercise ownership.

Prudential regulation. Prudential regulation and supervision are important in helping to ensure the safety of deposits made by the poor. The capacity of financial regulatory authorities to understand microfinance methodologies and effectively supervise MBFOs needs to be improved in tandem with the implementation of regulatory reforms. However, MBFOs that operate with closed memberships or at a small scale may well merit exemption from such regulation. The argument for this is especially strong where the government lacks capacity to provide effective supervision. Second-tier entities may instead take on a monitoring and supervisory role of their members to ensure effective governance, transparent reporting, and protection against fraud. In Guatemala, for example, CGAP recently funded the development of a rating agency to set standards for, and provide transparency on, credit union performance.

Organizational sustainability. Organizations receiving funding should commit to a sustainability plan, with funding structured to ensure that the plan is carried out (with tranches based on performance targets). Capacity building should be emphasized over funds for on-lending, which can distort governance and negatively affect portfolio quality.

Length of support. Institution-building processes often take longer and are more costly than originally envisioned. For example, the institution-building project in Mali took more than 10 years before the CVECA system reached full technical and financial sustainability. The human and financial resources available within small rural communities limit management and governance capacity. Projects often require more supervision, support, and monitoring than initially assumed. Where community resources and capacity are severely limited (in remote communities, for example, or where economic activity is at a very low level), informal group models may be more appropriate. Institutions should not be pushed to grow more quickly than their capacity allows.

Lessons Learned

Challenges remain for the Bank and donors to provide cost-effective support that does not create long-term dependency. Any subsidies provided should be tied to a time frame (that is, not permanent), linked to performance targets, and matched with member resources. Accounting at the level of the MBFO should be transparent and clearly identify any subsidies received. Any support to service providers and second-tier structures should have service charges built in from the start, and low-cost structures should be sought that can be sustained when the project ends.

Deposit mobilization is essential to MBFOs. A savings-first approach contributes to project ownership among members as well as to self-reliance and local autonomy. Effective governance and transparent monitoring and reporting systems are essential to protect against fraud and poor management of savings. Maintaining a balance of depositors to borrowers is important, in order to avoid borrowers putting the institution's deposits at risk.

When considering legal and supervisory reform (for example, prudential regulation of deposit-taking institutions), caution is required regarding the potential side-effects of new legislation, the cost of supervision, and the capacity of the supervisory agency.

Recommendations for Practitioners

Box 8.22 Potential investments

- Long-term, performance-based technical assistance focused on selected MBFOs.
- Monitoring mechanisms for MBFOs.
- Capacity building to strengthen or create federations or networks.
- Development of policy and regulatory frameworks for MBFO operations and protection of depositors.

Source: Authors

Recent successes in strengthening credit unions and savings and loan cooperatives indicate that focusing on the retail level, combined with addressing policy and legal issues, can be most effective. Investments should (box 8.22):

- Offer technical assistance to MBFOs that are most open to receiving it, rather than providing blanket assistance to all MBFOs. These MBFOs can provide a positive demonstration model to others (box 8.23).

Box 8.23 Guatemala: institutional strengthening of savings and loan cooperatives

An approach of selecting and focusing efforts on leading cooperatives/credit unions that are most open to change was developed and tested in Guatemala between 1987 and 1994. Rapid growth in outreach and financial performance of 20 selected credit unions resulted in increases in membership from 60,000 to 200,000, in loan portfolios from US$13 million to US$54.5 million, and in deposits from US$5 million to US$59 million. Portfolio delinquency (portfolio at risk over 30 days) fell from 19 to 7 percent over the same period.

Source: Westley and Branch 2000

- Link technical assistance and financial support to performance criteria. Reporting and monitoring systems need to track performance against agreed indicators in key areas such as portfolio quality, efficiency, sustainability, and asset protection.
- Ensure that strengthening MBFOs is the primary goal, not subsidizing second-tier federations. Increased MBFO capacity and resources should create more sustainable demand for such federations.
- Introduce regulation and supervision mechanisms for MBFOs that have grown beyond a small community base and represent a potential threat to the financial system or to large numbers of depositors. This effort may require capacity building within the supervisory agency of the financial institution. Interim supervision and monitoring by a second-tier structure can offer a level of protection to depositors.

Selected Readings

Asterisk (*) at the end of a reference indicates that it is available on the Web. See Appendix 1 for a full list of Websites.

CGAP (Consultative Group to Assist the Poor). 2002. "Consensus Microfinance Policy Guidance: Regulation and Supervision." Washington, DC: CGAP. *

Staschen, S. 2001. "Financial Technology of Small Farmer Co-operatives Ltd. (SFCLs): Products and Innovations." Working Paper 2. Rural Finance Nepal, Katmandu.*

References Cited

Chao-Beroff, R. 1999. "Self-Reliant Village Banks, Mali (Case Study)." Eschborn: Consultative Group to Assist the Poor (CGAP).

DGRV. http://www.dgrv.org/publish/article_60.html.

Ouattara, K., C. González-Vega, and D. H. Graham. 1999. "Village Banks, Caisses Villageoises, and Credit Unions: Lessons from Client-Owned Microfinance Organizations in West Africa." Economics and Sociology Occasional Paper No. 2523. Bethesda: USAID Best Practices Project.

Westley, G. D., and B. Branch. 2000. "Safe Money: Building Effective Credit Unions in Latin America." Washington, DC: Inter-American Development Bank (IADB).

This investment note was written by Douglas Pearce (CGAP), Annabel Mulder, and Andrew Goodland, with researcher support from Amitabh Brar (CGAP).

Commercial Banks Entering Rural Markets

When contemplating entry into rural markets, commercial banks can choose from a number of models. The choice depends on the importance of a given rural market within each bank's overall strategic plan, the available business opportunities, the resources it is willing to invest, and its appetite for risk. Some initiatives undertaken by commercial banks over the past decade are outlined below.

Integrating Rural Finance and Financing for Agriculture into a Commercial Bank's Mainstream Business

This approach is usually chosen by a financial institution that has realized that its traditional mainstay business is becoming increasingly competitive and that it must focus on new markets to survive or to increase profitability. This strategic business reorientation can take place in farsighted institutions without donor support (box 8.24), although in other cases support from donors will be instrumental. Traditionally donors and governments have supported interested banks through special-purpose credit lines and technical assistance. In many instances, however, banks have continued to focus on the supported markets after a project ends *only* if the bank's owners and top management are highly supportive and consider it to be in their own interest. The example in box 8.25 demonstrates how significant donor involvement and an innovative three-party approach resulted in increased lending for agricultural equipment.

Establishing a Separate Unit within a Bank to Serve Nonpriority Markets

Many commercial banks are quite interested in entering new markets, such as lending to agri-businesses and SMEs, while remaining focused on their core business. A good choice in this case can be to set up a separate unit as a profit center and allow it to develop a distinct culture and business model. The European Bank for Reconstruction and Development (EBRD) has used this model successfully to introduce small/medium sized enterprise (SME) lending to commercial banks in Kazakhstan (box 8.26). Another example is Kingdom Bank in Zimbabwe, which has established a separate microfinance division with the assistance of ACCION International.

Box 8.24 Banco del Pichincha

Banco del Pichincha has developed a strong rural finance program as part of its overall strategy to become Ecuador's leading retail banking institution. In pursuit of this goal, Banco del Pichincha has established a network of over 220 branches serving even remote villages. In 2001, Pichincha was providing almost 20,000 small loans to peasants and rural dwellers with an arrears rate of only 5 percent. The bank's relationship with farmers has grown through its engagement with agro-processing industries, to which the bank provides cash management services. One of these services is to deposit payments into the savings or checking accounts of the small-scale farmers who supply inputs to the industries. Through managing these accounts, the bank has learned about small-scale farmers' income levels and cash flow. It has tailored specific loan products for these farmers, which has allowed better utilization of the bank's costly rural infrastructure.

Source: Buchanau et al. 2003

Box 8.25 Lending for agricultural equipment: the German Romanian Fund in Romania

Romania's farmers often lack the financial resources to buy equipment, while commercial banks lack secure financial products and procedures to reach these rural clients. Guaranteeing equipment loans is the main issue. Banks do not want to take pledges on equipment they might have to sell if a client defaults and farmers do not have collateral. The German Romanian Fund, implemented by Horus Development Finance in Romania, offers a solution both to farmers and commercial banks: an innovative product consisting of a bank equipment loan with a buy-back clause from the equipment supplier. The commercial bank and the equipment supplier sign a framework cooperation contract. Then, for each loan, a credit contract guaranteed by a buy-back clause is signed by the three parties (bank, client, and supplier). All three parties benefit. The banks reach a new clientele and do not have to deal with the equipment in case of default. The equipment suppliers can sell more equipment and are very interested in buying back the equipment, if necessary, at a price lower than the market price. The rural clients gain access to financial resources to buy new as well as secondhand equipment.

Source: Horus Development Finance 2004

Box 8.26 The European Bank for Reconstruction and Development (EBRD) lending program for small/medium sized enterprises (SMEs) in Kazakhstan

The major commercial banks in Kazakhstan that qualified under EBRD guidelines were provided with significant technical assistance to set up a separate department with separate staff, credit procedures, and management, often located in a separate building. In the early stages of the project, the SME financing units were managed and tightly controlled by international consultants, who installed all the systems and procedures and provided training to bank staff. Based on the success of the Kazakhstan project, EBRD expanded the program to other Central Asian countries in cooperation with the International Finance Corporation (IFC).

Source: Author, 2003

Establishing and Spinning off a Separate Unit to Serve Rural Markets and Low-income Populations

This approach goes one step further than the establishment of a separate unit: the goal is to spin off the unit once it has demonstrated its profitability. Financial Bank is using this model in West Africa, with the aim of establishing a network of small, special-purpose banks (box 8.27).

Establishing a Separate Unit Managed by a Service Company

Service companies are nonfinancial companies that originate and service loans on behalf of a bank, for a fee (box 8.28). Loans are booked on the bank's balance sheet, but all staff members are employees of the service company. The service company identifies customers and initiates transactions while taking advantage of the bank's funds as well as of its back-office processing and administrative structures. This model has numerous advantages: it does not require a financial institution license; initial capitalization is very

small, because the company does not need loan funds; and the company uses many parts of the bank's infrastructure, which reduces costs. ACCION International has worked with banks in Haiti (Sogebank), Ecuador (CrediFe), and Brazil (Banco Real) to establish service companies.

Box 8.27 Financial Bank of Benin and Chad

Financial Bank (Benin, Chad) formed microfinance units with the objective of spinning them off once they achieved outreach, sustainability, and profitability. The spun-off units, called Finadev, are private commercial microfinance institutions, with a banking group as the main sponsor and shareholder, international financial institutions as shareholders and partners, and a technical partner (Horus) directly involved through equity capital and technical assistance.

Finadev Benin and Finadev Chad are freestanding microfinance units focusing on low-income customers. They currently target three customers segments, presently all urban: women microentrepreneurs, especially those active in trade; small/medium sized enterprises (SMEs); and employees in the formal sector. Loans are used mainly to fund housing improvements or informal businesses. Finadev Chad already has a branch in the second city of the country, Moundou, which is located in the main agricultural area. In addition to their businesses, many of the women micro-entrepreneurs served by Finadev have a cereal storage activity. A study is being conducted to develop a product to finance purchases of small-scale agricultural equipment. Collaboration with an agricultural development program would certainly help Finadev to develop appropriate products. Finadev Chad intends to be, within a few years, strong enough to serve other types of customers in rural southern Chad. Important economic reforms are underway to strengthen the private sector in this region. These reforms require that new intermediation mechanisms become available to finance agricultural production and rural activities, an outcome that will occur only if a sustainable and professional financial institution exists.

Source: C. Falgon, Horus Development Finance, personal communication, 2004

Box 8.28 Sogebank, Haiti

Sogebank, Haiti's largest locally owned commercial bank launched its microcredit program in 2000, after a change in legislation made such operations possible. Sogebank established SogeSol (Société Générale Haïtienne de Solidarité), an independent, nonbank, microlending company, as its service company. SogeSol provides loan origination and administration services to Sogebank, which issues the loans. ACCION International is a shareholder of SogeSol, has provided technical assistance, and assumed the management contract for the company in 2004. As of June 2004, SogeSol had established nine branches in Haiti's capital and secondary cities, serving over 6,400 clients with an average loan size of approximately US$900. Its portfolio quality remains a challenge owing to political unrest and hurricane damage, which have affected its clients' repayment capacity.

Source: www.accion.org/about_where_we_work_program.asp_Q_T_E_17

Success Factors for Commercial Banks in Rural Areas

The following *success factors* suggest ways that commercial banks can orient their operations to work profitably in rural areas.

Portfolio diversification. A financial institution can reduce its portfolio risk significantly through geographic diversification, customer diversification, and product/service diversification. Diversification works only if economies of scale are achieved and if an institution invests in understanding the needs of its potential clients, develops products that respond to their needs, and implements a cost-effective, efficient management information system.

Marketing responsive products. Experience demonstrates that even poor rural clients are able and willing to pay for financial products that meet their requirements and needs. Clients often value deposit and payment services more than credit services. Undertaking marketing campaigns about financial products and services is an important activity that is often overlooked.

Management structure and good governance. Good governance and an appropriate management structure are major prerequisites for the rural finance activities of any commercial bank to remain sustainable and profitable. Other key elements for success include a commitment from management, transparent policies and procedures, and strong compliance.

Management information system and business approach. A reliable management information system is central to the successful operation of any commercial bank in any business environment, including rural finance. Investments in technologies that enable the institution to process transactions more efficiently, control repayments, and reach out to customers more effectively will reduce costs, which may make the provision of services to rural and low-income clients more attractive. Each banking business unit requires a separate business model and practical approaches to deal with its clients, regardless of whether the unit engages in corporate or rural finance. Appropriate human and technical skills, combined with appropriate, continuous training, are also economic drivers in the commercialization of rural finance.

Benefits

For commercial banks, low-income and poor clients constitute a large potential market for retail financial services, and a growing number of commercial banks have successfully entered this market. The benefits for commercial banks and their potential clients can be numerous:

- Commercial banks have potential comparative advantages such as recognizable consumer brand names, existing infrastructure and systems, and access to capital.
- Banks provide a broad range of complementary products to their customers and have a competitive advantage over other entities that provide only one or a few services. For example, rural finance customers may perceive that there is greater value in dealing with a bank, where they can obtain a loan and also open a savings account in which to deposit the loan as well as their earnings.
- By offering savings accounts, banks provide a valuable service to rural communities, where savings accounts are more effective than credit in reducing risk.

- Wider participation of commercial banks in rural finance mobilizes funds on a wider scale and spreads risk over large areas. It can also introduce much-needed professionalism.
- They are a conduit to the economic food chain, by creating an efficient banking market. By making funds more widely available in rural areas, commercial banks create new opportunities for customers and communities to link to the wider economy.
- Commercial banks face increasing competition in traditional markets. By exploring new markets such as rural finance, they may generate growth at acceptable profit margins.
- Commercial banks offer great potential to scale up financial services and reach a significantly larger number of clients than MFIs or other nonbank financial institutions.

Policy and Implementation Issues

A coherent policy environment. Despite general improvements in the policy environment for financial sector programs, the policy environment for commercial banks in many countries remains unattractive, which hampers sustainable growth in rural finance operations.

Inadequate financial infrastructure. Inadequate financial infrastructure—in other words, the legal, information, and regulatory and supervisory systems for financial institutions and markets—remains a major problem. Most developing country governments focus on creating institutions or special programs to disburse funds to the poor. They give little attention to building the financial infrastructure that can support, strengthen, and ensure the sustainability of such institutions or programs and to promoting private sector participation in rural finance. Problems related to the lack of infrastructure include the absence of a legal framework that is conducive to the emergence and sustained growth of commercial banks; the lack of regulatory and supervisory systems for commercial banks to engage in rural finance; and the inadequate development of accounting and auditing practices and professions.

Limited institutional capacity at the retail level. Most commercial banks have insufficient capacity to expand the scope and outreach of services on a sustainable basis to most of their prospective clients, including the rural poor. Many institutions lack the capacity to leverage funds, including public deposits, in commercial markets; cannot provide a range of products and services compatible with the characteristics of their potential clients; lack adequate networks and delivery mechanisms to reach the poorest of the poor in a cost-effective way; have not demonstrated the vision or commitment to ensure that they can become financially sound and sustainable (and thus more independent) within a reasonable period; and lack the capacity to manage growth prudently.

Inadequate investments in agriculture and rural areas. Agricultural growth, which underpins much of the growth in the rural nonfarm subsector, significantly influences the development of rural finance markets. Many developing economies do not make

adequate investments to foster agricultural growth and the development of rural finance, thereby limiting the development of sustainable financial services. Insufficient investment in physical infrastructure (including roads, irrigation, electricity, and support services for marketing, business development, and extension) continues to heighten the risk as well as the cost for commercial banks seeking to expand their markets in rural finance. It also discourages private investments in commercial banking on any significant scale.

Lessons Learned

- Adoption of the financial system development approach is the key to achieving sustainable results and to maximizing development impact. This approach emphasizes the development of an enabling policy environment, financial infrastructure, and financial intermediaries that are committed to achieving financial viability and sustainability within a reasonable period and that can provide a variety of financial services (not just credit) to the poor.
- Clients are more concerned about access to services that are compatible with their requirements than about the cost of those services.
- Financial institutions that are committed to providing rural finance services require considerable technical assistance for capacity building.
- Among poor rural households, the demand for savings services is as strong as or stronger than the demand for credit. The wider availability of savings services can have a significant impact on the sustainability of financial institutions and on poverty reduction.

Recommendations for Practitioners

Recommendations for practitioners involved in rural finance include:

- Increase technical assistance for capacity building so that commercial banks can expand their outreach and develop new products and services tailored to clients' requirements.
- Focus also on the demand for savings services and other services, such as payment services (remittances) and insurance.
- To ensure the financial viability and sustainability of commercial banking in rural finance, pro-poor innovations need to be encouraged, along with financial and technical assistance incentives for commercial banks that demonstrate a commitment to reaching out to poorer clients.
- Document and use best practices.

Rural Leasing to Finance Long-Term Assets

Several special-purpose institutions and products are quite suitable for financing rural enterprises and farms, especially larger ones. They are also relevant for small farmers but to a lesser extent. Rural leasing is outlined below.

In many countries, lack of access to long-term financing for capital investments is one the most pressing issues in rural areas. Leasing has long been recognized as one solution, as it allows the circumvention of such financial market imperfections as lack of a collateral registry and collection enforcement mechanism, two of the major obstacles in equipment financing (boxes 8.29, 8.30, and 8.31).

Leasing is a financing tool through which the provider (lessor) owns the equipment and permits the client (lessee) to use it in exchange for periodic payments (lease payments). Leases are also a means of eventually acquiring equipment (and not just its use), as ownership is generally transferred to the lessee at the end of the lease period, either automatically or at a token price.

Leasing is likely to be more accessible and affordable to rural enterprises than credit. Farmers and rural enterprises are particularly constrained by the lack of assets that can be used as collateral. Leasing overcomes this constraint, because no collateral needs to be registered. The lessor is the owner, not just the financier, and the equipment can quite easily be recovered from a lessee who is remiss in paying the lease obligations. Leases typically have lower down payments than loans, making them more accessible to lower income people.

In a Bank survey of 10 leasing companies in 2003, the surveyed companies indicated that they require down payments of 15-25 percent as compared to 30-40 percent required by banks in those countries for equipment financing. These advantages not only result in faster processing but lower overall transaction costs. IFC has often initiated the establishment of leasing companies in countries where financial market conditions do not allow for long-term bank financing on commercial terms or where there are no suitable commercial banks. In more developed financial markets, commercial banks often establish leasing subsidiaries to provide long-term financing that is considered too risky for regular bank financing. There is experience, though limited, in microleasing and leasing for agricultural equipment.

In general, less rather than more regulation is useful. There should be clear regulations that classify leasing companies as non-deposit-taking financial institutions that are not subject to the restrictions of banking laws, including reserve and liquidity requirements. An enabling legal framework includes equally clear definitions for the legal ownership of leased assets, repossession of leased assets in case of default, and liability in case of third-party losses.

Leasing regulations are in general quite simple and uncontroversial, and thus they offer a good opportunity for fast action by policy makers motivated to support rural development. Desirable but not required features include a functioning market for secondhand equipment and affordable and accessible repair and maintenance facilities.

Box 8.29 Network Leasing Corporation, Pakistan

Network Leasing Corporation (NLC) in Karachi and Lahore, Pakistan predominantly serves small and micro businesses. NLC innovated the leasing process by introducing postdated checks as a secure payment method and required clients to open bank accounts for this purpose. Payment patterns can vary according to the lessee's cash flow patterns, and secondhand equipment can be leased. NLC includes life insurance for the lessee in the contract in addition to coverage of the leased assets. NLC has launched a program to increase its business in rural areas in the northwestern provinces of Pakistan with international assistance.

Source: Havers 2003

Box 8.30 Development Finance Corporation of Uganda Leasing

The Development Finance Corporation of Uganda (DFCU) has pioneered leasing activities in Uganda. DFCU allows the leasing of secondhand equipment and uses postdated checks to ensure payment. Its in-house engineers monitor proper maintenance of leased equipment. DFCU's main clients are small- and medium-sized urban enterprises, nearly all of which are finance leases. Recently the company has expanded to small and micro businesses, including beekeepers, mushroom growers, maize and rice millers, cotton ginning companies, tractor users in rural areas, and cooking equipment for hotels and schools, milk coolers, bakery equipments, used vehicles, photocopying machines, and carpentry equipment. The Shell Foundation and DFCU entered into a partnership to finance leases for energy-efficient equipment including equipment used in honey processing, tile manufacturing, and fruit processing. In addition to Kampala, DFCU has branches in 6 towns and has 84 employees.

Source: Authors

Box 8.31 Caisse d'Epargne et de Credit Agricole Mutuel, Madagascar

In Madagascar, the Caisse d'Epargne et de Credit Agricole Mutuel (CECAM), a cooperative for agricultural finance, has introduced hire-purchase for a range of assets including farm implements, dairy cows, artisanal equipment, bicycles and sewing machines. Payment schedules are adapted to the crop cycle, and local member groups monitor the security of the hired items.

Source: Fraslin 2003

Selected Readings

Asterisk (*) at the end of a reference indicates that it is available on the Web. See Appendix 1 for a full list of Websites.

AFRACA (African Rural Credit and Agricultural Association). 2003. *The Role of Commercial Banks in Rural Finance*. Nairobi: AFRACA.

The Banker. February 2005 issue. *Malloch-Brown, M. "Microfinance Joins the Mainstream," p. 12. "Banks Can Reach Out to the Poor," p. 6. (No author listed on website*

De Gobbi, M. S. 2003. "The Role of a Professional Association in Mutual Microfinance: The Case of Madagascar." Geneva: International Labour Organization (ILO), Social Finance Program.

DFID (Department for International Development, UK). 2005. "Banking the Underserved: New Opportunities for Commercial Banks." Policy Division Working Paper. Financial Sector Team, Policy Division. DFID, London. http://www.dfid.gov.uk/pubs/files/banking-underserved.pdf *

Gutin, J., and R. Young. 2005. "Khan Bank, the Agricultural Bank of Mongolia." January.

Harper, M. 2004. "Should a Commercial Bank Enter the Micro-Finance Market?"

Harper. M., and J. Heney. 2004. "Lesson # 4: Commercial Banks and Rural Finance." Online lesson, Rural Finance Learning Centre. http://www.ruralfinance.org/servlet/CDSServlet?status=ND01NTY4LjExNTEzJjY9ZW4mMzM9bGVzc29uJjM3PWluZm8~ *

Kilkenny, M., and R. W. Jolly. 2005. "Are Rural Credit Markets Competitive? Is There Room for Competition in Rural Credit Market? *Choices* (20)1. http://www.choicesmagazine.org/2005-1/2005-1.pdf. *

Lopez, C., and E. Rhyne. 2003. "The Service Company Model: A New Strategy for Commercial Banks in Microfinance." *ACCIÓN Insight 6* (September 2003). *www.accion.org/micro_pubs_list.asp*.

Meyer, R. 2005. "Brazil's Banks Adjust View of Their Market." Online lesson, Rural Finance Learning Centre. http://www.ruralfinance.org/servlet/CDSServlet?status=ND01NDE4LjE5ODYzJjY9ZW4mMzM9ZGlnZXN0JjM3PWluZm8~ *

References Cited

ACCION. www.accion.org/about_where_we_work_program.asp_Q_T_E_17. *

Buchanau, J. and Hidalgo A. 2003. "Servicios financieros privados en el área rural de América Latina: situación y perspectivas." In *Desarrollo territorial rural en América Latina y el Caribe: manejo sostenible de recursos naturales, acceso a tierras y finanzas rurales*, Inter American Development Bank, Washington, DC. http://www.iadb.org/sds/publication/publication_2567_s.htm.

Fraslin, J. H. 2003. "CECAM: A Cooperative Agricultural Financial Institution Providing Credit Adapted to Farmers' Demand in Madagascar." Paper presented at Paving the Way Forward for Rural Finance: An International Conference on Best Practices, sponsored by USAID and hosted by BASIS CRSP partner, World Council of Credit Unions, Washington, DC.

Havers, M., 2003. "Micro Enterprise and Small Business Leasing–Lessons from Pakistan." *Small Enterprise Development Journal* 10(3).

This investment note was written by Renate Kloeppinger-Todd, ARD, with researcher support from Romeo Esangga, ARD, and Ajia Nair, SASAR.

Vietnam: Mobile Banking for Rural People

What's Innovative? Mobile banking—trimming transaction costs of serving rural and remote areas.

The Rural Finance Project was approved in 1996 with World Bank funding of US$110 million. The project has supported several key components of the country assistance strategy, including: (1) assisting in the transition to a market economy; (2) strengthening the rural finance system through finance to agriculture, SMEs, and technical assistance; and (3) reducing poverty by promoting growth. Living conditions are to be improved by encouraging private sector investments, strengthening the banking system, and increasing access of the rural poor to financial services. The seven banks that participated in the project had to complete an institutional development program prior to being admitted. The dominant bank within the project is a public bank. The project has supported several financing initiatives, reflecting the various challenges facing Vietnamese communities. One innovative feature of this rural finance project is its mobile banking operations.[10]

Project Objectives and Description

Mobile banking provides banking services to remote and mountainous areas without bank branches, through the use of specially equipped vehicles. The project's institutional building component financed 159 vehicles at a cost of US$22,000 each. These vehicles were distributed to bank branches to provide financial services, including arranging and disbursing loans, collecting loan repayments, and taking deposits. Each vehicle carries three bank employees.

The mobile banking operation has been effective, with 315,000 rural people receiving financial services. Experience so far indicates that each month, on average, one mobile banking unit mobilizes about 2,000 deposit accounts (US$1.2 million), releases about 1,900 loans (US$1 million equivalent), and collects 1,400 loan repayments (US$650,000 equivalent). The operation is profitable, generating a net monthly income before taxes of about US$1,000, after deductions are made for provisions (reserve for defaulted loans), the cost of running and maintaining the vehicles, the cost of funds, and operating costs.

Given its financial viability, the public bank will maintain its mobile banking operation. A follow-up project (Second Rural Finance Project) initiated in 2002 builds on the experiences and success of the earlier project. An additional 210 vehicles will be provided to several participating banks.

Benefits and Impacts

By overcoming a key impediment to providing rural finance—high transaction costs—mobile banking can be a suitable delivery mechanism for remote areas. The main benefits

[10] Sources: "Sustainable Management of Agriculture and Natural Resource Management Case Study, Antalya." Rural Finance Project Implementation Completion Report (2001). World Bank Task Team Manager's comments.

are cost reduction and increased geographical coverage. In Vietnam impact studies of the mobile banking project have found that:

- It provided better financial services to people in remote areas by allowing access to formal banking services. Previous financing opportunities had been limited to informal moneylenders charging extremely high interest rates.
- Borrowers served by the mobile offices managed to expand their businesses, and 99 percent of them had increased their income as a result of the project.

Lessons Learned and Issues for Wider Applicability

Mobile banking can be considered an alternative to "fixed" delivery mechanisms (branches of financial intermediaries) in areas where it is not feasible to maintain a network of rural branches. The advantage of a mobile office (attached to a branch) is that it can visit remote rural areas for loan analysis, disbursement, and repayment depending on the needs of the area (for example, weekly or monthly). This flexibility permits one office to achieve greater geographical coverage and thus reduces fixed costs. This successful experience in Vietnam, and the continuing use of mobile banking by Vietnam's dominant rural bank, demonstrates that this operation is a cost-effective way of delivering rural finance.

The applicability of mobile banking to other countries and settings will depend on the cost effectiveness in a given setting—for example, transportation costs may vary according to road conditions and networks—as well as cultural and social compatibility. Although the initial capital investment in mobile offices is substantial, these costs need to be seen in relation to the cost of establishing and maintaining a fixed delivery mechanism in remote areas. Indeed, the mobile banking services in remote rural areas of Vietnam proved to be much more cost effective than the established branches in those areas.

The commitment of bank management to increase outreach and provide people in remote areas with access to financial services is seen as a key factor in the success of the project. Given that mobile banking operations require that monetary transactions are conducted away from the branch office, security is also an important issue. Consequently, a key precondition for successful mobile banking operations is low levels of crime in the countryside and the country as a whole, as well as a well-maintained system of law and order.

Country	Vietnam
Project Name	Rural Finance Project
Project ID	P004847
Project Cost	US$139.7 million
Dates	FY 1997 – FY 2002
Contact Point	Arie Chupak, Task Team Leader, The World Bank

Mongolia: Technological Innovation Serving Rural Areas (Khan Bank of Mongolia)

What's Innovative? Khan Bank has become a leading provider of financial services to rural Mongolia through the innovative use of information and communications technology in an extensive branch network.

The Khan Bank of Mongolia is an institution best described by superlatives. It is the leading provider of financial services to rural Mongolia. It was named "Best Bank in Mongolia for three consecutive years (most recently in 2006) for its achievements as a leading financial institution delivering innovative financial services to all Mongolians. One of the Bank's greatest assets is its branch network, comprising 394 points of service, which is much more extensive than that of any other bank operating in the country. The branch network effectively reaches 98 percent of rural communities and one out of every two Mongolian households.

Of Khan Bank's 394 offices, more than 150 are fully interconnected through satellite antenna, fiber optic cable, or wireless modem. The network improves their competitiveness through efficient, low-cost transaction processing and accounting and delivers their rapidly developing electronic and card banking products in real time. Over 65 percent of loans and 85 percent of deposits are handled over this network. Additionally, Khan Bank has been utilizing solar and wind power in over 100 rural branches in areas where electricity is either unavailable or too sporadic to be reliable. With this technological innovation, the Bank was able to introduce its "Express Micro" loans, which are ideally suited for traders and small businesses and are approved and disbursed within one to two days for qualifying customers. Mongolian government agencies and companies with a need for countrywide reach to the rural population utilize Khan Bank's network to deliver services.

Khan Bank offers debit cards to cross-border traders traveling to China to minimize the risk of carrying cash over long distances. Khan Bank now operates through the Agriculture Bank of China to enable its debit cards to be used at ATMs and point of sale devices, enabling cashless travel and reducing Khan Bank's risk of theft-related default. The bank is planning to offer the reverse opportunity for Chinese traders.

Recently, Khan Bank and a local telecom provider started a nationwide upgrade to deliver internet and telecommunication access at rural level. LMI/Mongolia will work with Khan Bank and the telecom provider to build the rural phone network. For this activity, Khan Bank's local branches will serve as hubs for providing point, multipoint wireless connectivity to the district town and surrounding *baghs*. They will be using an innovative VoIP solution ("rural telco in a box") in conjunction with the telecom network at the Khan Bank branches to provide rural and remote locations with low-cost local and international telecom services. In providing rural telecom access, Khan Bank is actively supporting telecom policy and regulatory reform efforts undertaken by Mongolia's information and communication technology agency and the World Bank.

Benefits and Impacts

The main economic benefits—the lower cost of capital, profitability, and increased geographic reach—have been achieved by providing a cost-effective and efficient branch network along with innovative technology, which are the keys to delivering financial services to this remote part of the world.

The impact of branch connectivity and wireless internet-based banking system has proved that:

- An innovative bank delivery system can provide better financial products and services to people in remote areas by allowing access to formal banking via the internet and a seamless wireless banking system.
- With this technological innovation, Khan Bank has provided products and services that are ideally suited to mobile traders and small businesses.
- A wireless rural phone network can be useful and affordable, offering sustainable applications such as emergency communications, distance learning, telemedicine (human and husbandry), tourism communication, and early warning for drought and fire hazards, which add value to financial products and services.

Lessons Learned and Issues for Wider Applicability

Heavy investment in proprietary electronic innovation and a well-established, connected branch network are essential in delivering a critical mass of innovative financial products and services in remote areas. The advantage of the network and seamless connectivity are that savings are posted in real time; loans are analyzed, approved, and disbursed in one to two days; and loan repayments are made electronically to avoid or minimize defaults.

The commitment of Khan Bank's management and investors to invest in innovative technology to increase outreach and provide people in remote areas with access to financial services is seen as a key factor in the success of the project.

It appears that Khan Bank's business model could be replicated. The applicability of this project to other countries and settings will depend, however, on the cost effectiveness in a given setting, which in turn depends on, for instance, the availability of good managers, openness of the government, cultural and social compatibility, and an enabling legal environment.

Country	Mongolia
Project Name	Agricultural Bank of Mongolia
Project ID	11710
Project Cost	$3.0 million
Dates	06/14/04 – 12/23/04
Contact Point	Mr. Peter Morrow, CEO

Madagascar: Microleasing for Agricultural Production

What's Innovative? Successful microleasing of agricultural equipment to farmers.

The Caisses d'Epargne et de Crédit Agricole Mutuels (CECAM)—an agricultural savings and credit union—was created in 1991 by a farmer organization with the technical assistance of a French NGO. The objective was to provide loan and savings services to agricultural households and farmer organizations. CECAM is a network of more than 170 local banks and regional credit unions, mainly based in less-favored rural regions, with more than 52,000 members (largely farm households). By the end of 2002, CECAM had become the largest financial institution in rural Madagascar. It provides a range of financial services, including working capital loans, grain storage loans, and term loans. In addition to these loan products, CECAM provides innovative microleases for agricultural equipment.[11]

Project Objectives and Description

Recognizing the need for farmers in Madagascar to obtain capital assets, CECAM developed a microleasing product together with a French NGO in 1993. CECAM microleases are offered on capital equipment required for agriculture, for rural crafts, and for domestic use (for example, sewing machines and solar lighting units). The CECAM leasing product is unique because it is targeted specifically at rural people. Leaseholders are required to be network members and to put down 20 percent of equipment value at lease initiation, with the remaining 80 percent to be paid at 30 percent interest over 10 to 36 months. The down payment must increase to 40 percent in the case of secondhand goods. Farmer groups at the village level are involved in screening potential borrowers. Because there are few secondary income sources in the area, these are not used to qualify for a lease. Instead, the microlease is secured by the equipment rental and through a verbal commitment of the member's solidarity group. During the payment term, CECAM retains ownership of the equipment. After the final payment, ownership is legally transferred to the client.

The payment schedule for microlease loans is largely adapted to fit the client's production cycle. For example, for certain agricultural businesses, payments have been structured to meet the business cash flow, with as little as four payments due over the course of a year. By 2002 CECAM's outstanding portfolio in leasing was US$1 million, or about 27 percent of the credit portfolio. The number of "leasing borrowers" was 2,564, corresponding to 8.9 percent of all borrowers and 5.5 percent of members. The average leasing amount was US$390 per leaseholder. Since 1993, CECAM has signed 23,000

[11]U. Andriantsivaliana and J.-H. Fraslin, "La Location Vente Mutualiste" (communication presented at the international seminar Le financement de l'Agriculture familiale dans le contexte de libéralisation : Quelle contribution de la microfinance? Dakar, Senegal, 2002); J.-H. Fraslin, "CECAM: A Cooperative Agricultural Financial Institution Providing Credit Adapted to Farmers' Demand in Madagascar" (paper presented at Paving the Way Forward for Rural Finance: An International Conference on Best Practices, sponsored by USAID and hosted by BASIS CRSP partner, World Council of Credit Unions, Washington, DC, 2003); A. Dowla and J. Herve, "Leasing: a New Option for Microfinance Institutions" (Technical Note 6, Weidemann Associates, Inc., Arlington; Development Alternatives, Inc., Bethesda, 2003).

lease contracts with 11,500 members. Repayment rate on all leases disbursed has been 95.8 percent. Key factors in the project's success are its project-specific product design, a large capital base, and farmers' involvement in managing the institution.

Benefits and Impacts

There are essentially two outcomes to this type of lease agreement: either the lease is paid in full and the client becomes the legal owner of the equipment, or the lease is terminated before the full value of the equipment has been paid, and the equipment remains legally in the hands of CECAM. The following benefits from microleasing can be identified.

Benefits for the leaseholder include:

- *Business strengthening.* During the lease term, entrepreneurs with scarce resources benefit from using the equipment. The impacts are: more efficient or increased agricultural production; crop or livestock diversification; or involvement and value-added in postharvest activities. Leasing can also enable diversification into secondary nonagricultural business. In all cases, the effect is to strengthen the farmer's business and increase income.
- *Asset building.* Since no collateral is needed (except for such animals as dairy cows or draft oxen), this product is accessible to individuals who would not otherwise have sufficient collateral to qualify for an equivalent loan. If leaseholders can meet the lease term, they become the legal owner of the equipment. Ownership builds the farmer's asset base and increases borrowing capacity for future lending transactions.

Benefits for the MFI are:

- *Limited transaction costs and risk.* Risk of default is reduced because the MFI retains legal ownership of the equipment—the collateral—until the lease is met. Transaction costs are lower than mid-term lending for agricultural equipment, because lease transactions can be arranged quickly and simply.

Lessons Learned and Issues for Wider Applicability

The key advantage of leasing compared to lending is that the leased equipment is usually sufficient to secure a lease transaction (although it can be complemented with a pledge, as in the case of CECAM), whereas lending usually involves the pledging of assets for collateral. The rapid growth of leasing in a number of countries suggests that leasing is addressing an unmet demand for financing.

Although it appears that rural MFIs are equipped to enter this market, MFIs should be aware of the risks involved in microleasing. These risks depend in part on the lifespan and salvage value of the asset, which influence the cost of the lease. In addition, the up-front costs of leasing may negatively affect the MFI's liquidity and profitability. Finally, because there are many fixed costs in signing a lease agreement, these will weigh more

heavily with microleasing (owing to a higher cost per dollar leased) than with larger-scale leasing.

Country	Madagascar
Project Name	Microleasing for agricultural production
Dates	1993-2003
Contact Point	CECAM, Madagascar or ICAR : icar@dts.mg